89-1999

No. ——

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

DIEBOLD, INCORPORATED,
Petitioner,

v.

UNITED STATES,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

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QUESTION PRESENTED

Does a taxpayer who amends a tax return to correct a substantive error that would have been improper under any set of accounting procedures make a change in "method of accounting" requiring prior consent of the Commissioner under § 446(e) of the Internal Revenue Code?

RULE 29.1 LIST

Petitioner, Diebold, Incorporated has no parent companies. All of its subsidiaries are wholly owned.

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Petitioner Diebold, Incorporated prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Federal Circuit entered in this case on December 19, 1989.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 891 F.2d 1579 (pp. 1a-8a, *infra*). The opinion of the United States Claims Court is reported at 16 Cl. Ct. 193 (pp. 9a-53a, *infra*).

JURISDICTION

The judgment of the United States Court of Appeals for the Federal Circuit was entered on December 19, 1989. The Court of Appeals denied petitioner's petition for rehearing on March 26, 1990. P. 54a, *infra*. The

jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTE AND REGULATION INVOLVED

Section 446(e) of the Internal Revenue Code, 26 U.S.C. § 446(e), provides:

> Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary.

The pertinent portions of Treas. Reg. § 1.446-1 are set forth in Appendix D to this petition.

STATEMENT

Petitioner, a manufacturer of security systems for banks and other financial institutions, began producing and selling automated teller machines ("ATMs") in the early 1970's. Each ATM was comprised of separate subassemblies known as "modules." The modular construction was designed to facilitate rapid on-site repairs. Petitioner provided service contracts to keep the machines in repair for an annual flat fee. If a module could not be quickly repaired on site, it was removed and replaced with one that functioned properly. The malfunctioning module then was returned to petitioner's service center, repaired, and returned to petitioner's pool of rotatable replacement modules. None of these rotatable replacement modules was held for sale.

After the first such service contracts became effective in 1976, petitioner's bookkeeping personnel inadvertently and incorrectly included the rotatable replacement modules in inventory,[1] even though they were not held for

[1] This was the way the bookkeeping personnel had treated and continued to treat spare parts for petitioner's physical security

sale but were permanently-owned capital assets.[2] As a result of this error, petitioner did not claim on its original tax returns for 1976 through 1979 any deduction for depreciation based on the diminution in value of its capital investment in the modules, nor did it claim the corresponding investment tax credit.[3]

Petitioner first became aware of its error in late 1979 and shortly thereafter brought the error to the attention of the IRS agents who were examining its 1976 and 1977 income tax returns. At the agents' instruction, in Octo-

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equipment. The service contracts for petitioner's physical security equipment provided for labor only. Replacement parts were sold, separately charged to customers, and treated as inventory for both record-keeping and tax purposes.

[2] Only items held for sale constitute inventory. *See, e.g.*, Treas. Reg. § 1.471-1; *Illinois Cereal Mills, Inc.* v. *Commissioner*, 46 T.C.M. (CCH) 1001, 1018 (1983), *aff'd*, 789 F.2d 1234 (7th Cir.), *cert. denied*, 479 U.S. 995 (1986).

Inventory is taken into account in determining the cost of goods sold, which is subtracted from gross receipts to determine gross income. Treas. Reg. § 1.61-3. Net income is then calculated by subtracting from gross income all deductions, including any deduction for depreciation of capital assets. To determine the amount to be subtracted from gross receipts for the cost of goods sold, the cost of additions to inventory during the year is added to the cost of opening inventory, and the cost of closing inventory is then subtracted. *See Commissioner* v. *Van Raden*, 650 F.2d 1046 (9th Cir. 1981).

[3] Under *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979), items come out of inventory only when they are either sold or physically abandoned. Thus, the fact that the modules were not held for sale not only meant that they were not inventory; it also meant that, since they would never be sold, they would remain in inventory until physically abandoned years later, even though petitioner would be taxed year after year on the service income that the modules generated. Unless petitioner corrected its error, no part of the cost of producing the modules would have been considered in determining petitioner's taxable income until petitioner abandoned the modules, a result that would have constituted a dramatic mismatching of income and expenses.

ber 1980 petitioner filed timely amended returns for 1976 and 1977 in which it claimed depreciation deductions for the modules and the corresponding investment tax credit.[4] Petitioner did not file Form 3115 to request the Commissioner's consent to a change in method of accounting.[5]

The examining agents agreed that the modules were not inventory and should not have been treated as such. They allowed petitioner to amortize the modules, a result that gave petitioner deductions roughly equivalent to the depreciation deductions it had claimed on its amended returns. But the Appeals Office of the IRS later reversed the examining agents' determination and disallowed petitioner's claims for refund in their entirety.

Petitioner then filed a suit for refund in the United States Claims Court for the tax years 1976 and 1977. The Claims Court granted summary judgment in favor of the government. The Claims Court ruled that, even if petitioner had mistakenly overpaid its taxes, amending the returns so as not to treat the modules as inventory constituted a change in "method of accounting" under I.R.C. § 446(e) that could not be made without the Commissioner's consent.

The Court of Appeals for the Federal Circuit affirmed. It held that

> even if [petitioner] were correcting an erroneous characterization of the replacement modules, the correction would still be considered a change in the method of accounting. . . . Therefore, [petitioner's] argument that the replacement modules were not held for sale and consequently could not properly be

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[4] At the same time, the company also filed amended returns for 1978 and 1979, years in which it also had made the error.

[5] Under Treas. Reg. § 1.446-1(e)(3)(i), a taxpayer who seeks to change his method of accounting must file Form 3115 to request the Commissioner's consent to the change.

treated as inventory under any accounting method is irrelevant.

P. 6a, *infra.* The Court of Appeals concluded that, because petitioner's correction would affect the timing of when its taxable income was reduced by the cost of manufacturing the modules, the correction necessarily constituted a change in method of accounting. Pp. 6a-7a, *infra.* A petition for rehearing and a suggestion for rehearing *en banc* were denied.

REASONS FOR GRANTING THE WRIT

This case presents a fundamental issue: does a taxpayer change his "method of accounting" within the meaning of the Internal Revenue Code when he merely corrects a plain substantive error that would have been improper under *any* set of accounting procedures? The decision below conflicts with decisions of other federal courts of appeals and the United States Tax Court, which have recognized, contrary to the ruling here, that the correction of such a substantive error does not constitute a change in method of accounting.

This case involves a far-reaching question of federal law that potentially affects thousands of tax returns, both personal and corporate. The standard for identifying a change in "method of accounting" that requires the Commissioner's consent is a matter of great importance in the operation of the Internal Revenue Code. The Court of Appeals' decision both expands the power of the Commissioner beyond what Congress intended, and substantially curtails the right of taxpayers to amend their returns and to file for refunds.

I. THE DECISION BELOW CONFLICTS WITH DECISIONS OF OTHER FEDERAL COURTS OF APPEALS AND THE TAX COURT.

In holding that it is "irrelevant" whether the practice to be corrected would be improper under any method of accounting, p. 6a, *infra,* the Court of Appeals reached a

conclusion that conflicts with decisions of other federal courts of appeals and the United States Tax Court. Other courts, not surprisingly, have reached the opposite conclusion: that the correction of a substantive error that would be wrong under *any* method of accounting is *not* what the Internal Revenue Code means by a change in method of accounting. Courts have reached this conclusion in interpreting both § 446(e), which requires a taxpayer who changes the method of accounting on the basis of which he regularly computes his income to secure the prior consent of the Commissioner, and I.R.C. § 481, which provides that adjustments must be made when a taxpayer's income is computed under a method of accounting different from that used to compute income in the preceding year.[6]

In *W.A. Holt Co.* v. *United States*, 368 F.2d 311 (5th Cir. 1966), the Fifth Circuit held that, when a taxpayer

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[6] I.R.C. § 481 provides in pertinent part:

> (a) General rule. In computing the taxpayer's taxable income for any taxable year . . .
>
> (1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then
>
> (2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.

The regulations under both § 446(e) and § 481 construe change in method of accounting to encompass "a change in the treatment of a material item." Treas. Reg. §§ 1.446-1(e), 1.481-1(a). Courts frequently look to the case law under § 446(e) and the regulation interpreting that provision in determining whether there has been a change in method of accounting under § 481. *See, e.g., Korn Indus., Inc.* v. *United States*, 209 Ct. Cl. 559, 532 F.2d 1352 (1976); *Schuster's Express, Inc.* v. *Commissioner*, 66 T.C. 588 (1976), *aff'd mem.*, 562 F.2d 39 (2d Cir. 1977).

discontinued the erroneous practice of charging off as bad debts accounts that were not actually worthless, the taxpayer had not changed its method of accounting within the meaning of § 481. The Fifth Circuit reasoned that the correction did not involve a change in the timing of deductions but involved the elimination of "*improper* deductions." *Id.* at 313 (emphasis supplied).

The Ninth Circuit's decision in *Mamula* v. *Commissioner*, 346 F.2d 1016 (9th Cir. 1965), recognizes the same principle. In *Mamula*, the taxpayer improperly used the deferred-basis method in calculating income from the sale of real property, and then sought to amend to report properly under the installment method. The Commissioner contended that the taxpayer was bound by his prior election. The Ninth Circuit rejected the Commissioner's contention. It held that the taxpayer could not be bound by an impermissible choice:

> The present case does not involve an election by a taxpayer to which he is conclusively bound. Indeed, the taxpayer could not be bound by his election for it was a nonallowable choice—it was not allowable and not allowed. No one was bound. We are not here concerned with a taxpayer who uses hindsight to learn that the method he had chosen, though proper, was not the most advantageous to him. We are rather concerned with an instance where the method chosen by the taxpayer is advanced in good faith, and later conceded to have been improper.

Id. at 1018-19.

The Court of Appeals' decision also conflicts with several decisions of the United States Tax Court.[7] For ex-

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[7] The Claims Court expressly acknowledged that, with respect to § 446(e), Federal Circuit case law—which the Federal Circuit has said includes decisions of the old Court of Claims, *South Corp.* v. *United States*, 690 F.2d 1368, 1370 (Fed. Cir. 1982)—is contrary to Tax Court case law. Pp. 37a-38a, *infra* ("Unlike several circuit courts, the Tax Court has granted taxpayers leeway to correct im-

ample, in *Schuster's Express, Inc.* v. *Commissioner*, 66 T.C. 588 (1976), *aff'd mem.*, 562 F.2d 39 (2d Cir. 1977), the Tax Court held that correcting the error of taking deductions for insurance expenses in excess of actual expenditures was not a change in method of accounting under § 481. 66 T.C. at 595-97 (citing *Holt*, 368 F.2d 311). The court concluded that, because the deductions "do not appear to properly belong in any taxable period," *id.* at 596-97, the correction did not involve the proper time for the taking of a deduction and, therefore, did not constitute a change in method of accounting.[8]

Similarly, in *Underhill* v. *Commissioner*, 45 T.C. 489 (1966), the Tax Court ruled that there had been no change in method of accounting where a taxpayer dis-

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permissible or incorrect accounting methods without securing the Commissioner's consent. * * * * [T]his unique policy of the United States Tax Court does not accurately reflect the law in this circuit.") (citations omitted).

Insofar as the Claims Court suggested that "several circuit courts" have extended § 446(e) to the correction of substantive errors that would be improper under any set of accounting procedures, the court was mistaken. To our knowledge, until this case no court had held § 446(e) applicable to such a correction. None of the circuit court cases cited by the Claims Court involved a taxpayer who sought to correct a tax treatment that would have been erroneous under any set of accounting procedures.

[8] Treas. Reg. § 1.446-1(e)(2)(ii)(a) provides that "[a] change in the method of accounting includes . . . a change in the treatment of any material item . . . ." A material item is defined as "any item which involves the proper time for the inclusion of the item in income or the taking of a deduction." By contrast, Treas. Reg. § 1.446-1(e)(2)(ii)(b) provides that a "change in method of accounting does *not* include adjustment of any item of income or deduction which does *not* involve the proper time for the inclusion of the item of income or the taking of a deduction." (Emphasis supplied). As examples of corrections not within the scope of § 446(e), the regulation cites "corrections of items that are deducted as interest or salary, but which are in fact payment of dividends, and of items that are deducted as business expenses, but which are in fact personal expenses." *Id.*

continued the erroneous practice of treating as discount income a *pro rata* portion of each payment on interest-bearing obligations purchased at a discount. The court deemed it decisive that the change involved not the taxpayer's choice of accounting procedures, but, rather, the character of the payments involved:

> The issue before us is the extent to which payments received by petitioner are taxable or nontaxable—*i.e., the character of the payment—not the proper method or time of reporting an item the character of which is not in question.* Petitioner should no more be precluded from reporting his payments on the correct basis than a taxpayer who has previously been reporting nontaxable income as taxable income would be required to continue to do so because of his prior error.

Id. at 496 (emphasis supplied).[9] The Tax Court applied the same principle in *Standard Oil Co. (Indiana)* v. *Commissioner*, 77 T.C. 349 (1981), where it held that the taxpayer could deduct, as intangible drilling and development costs, expenditures associated with constructing offshore drilling platforms which the taxpayer had initially capitalized and expensed. *Id.* at 379. The court

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[9] The Tax Court has recently underscored the distinction between the determination of the proper characterization of an item, and the timing consequences that may result from such a determination:

> In the case before us, as in *Underhill* and *Standard Oil,* there is no timing issue to which section 446 is applicable because the determination of timing will automatically follow from the outcome of the character issue. . . . Although there is a timing consequence to the outcome of the characterization, it is automatically determined by the characterization and no change of accounting within the meaning of section 446 is involved.

Coulter Electronics, Inc. v. *Commissioner,* 59 T.C.M. (CCH) 350, 365 (1990). Unlike the Federal Circuit, the Tax Court thus clearly recognizes that a change in the characterization of an item does not constitute a change in method of accounting merely because it affects the time of reporting the item.

held § 446(e) inapplicable: "Such correction of internal inconsistencies does not constitute a change in accounting method." *Id.* at 383.[10]

In both *Underhill* and *Standard Oil*, the Tax Court relied upon *Beacon Publishing Co.* v. *Commissioner*, 218 F.2d 697 (10th Cir. 1955), and *Thompson-King-Tate, Inc.* v. *United States*, 296 F.2d 290 (6th Cir. 1961), cases decided under the predecessor to § 446(e) that also reveal the departure from precedent made here.[11] In *Beacon*, the Tenth Circuit held that a publisher could correct, without the Commissioner's prior consent, an error in its treatment of sums received for prepaid newspaper subscriptions. The court concluded that the taxpayer had not changed its method of accounting:

> [A] taxpayer may, without the consent of the Commissioner, apply the method of accounting which he has adopted, though not theretofore applied to a particular item, when that change will correct errors and clearly reflect his income.

218 F.2d at 702.[12] *Thompson-King-Tate* involved a taxpayer's election to report income from long-term con-

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[10] *See also Silver Queen Motel* v. *Commissioner*, 55 T.C. 1101 (1971); *North Carolina Granite Corp.* v. *Commissioner*, 43 T.C. 149 (1964); *Evans* v. *Commissioner*, 55 T.C.M. (CCH) 902 (1988).

[11] The regulations under the Internal Revenue Code of 1939 provided that a taxpayer could not change its system of accounting without the Commissioner's consent. *See Beacon*, 218 F.2d at 701; Treasury Regulation 111 § 29.41-2 (1943); *Thompson-King-Tate*, 296 F.2d at 294; Treasury Regulation 118 § 39.41-2 (1953). Section 446(e) was intended to codify this requirement. *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. A158 (1954), *reprinted in* 1954 U.S. Code Cong. & Admin. News 4017, 4297; S. Rep. No. 1662, 83d Cong., 2d Sess. 300 (1954), *reprinted in* 1954 U.S. Code Cong. & Admin. News 4621, 4940.

[12] In addition to *Underhill* and *Standard Oil*, *Beacon* has been cited with approval in other cases under the 1954 Code. *See Monfort of Colorado, Inc.* v. *United States*, 561 F.2d 190, 197 (10th Cir. 1977); *Holt*, 368 F.2d at 312.

struction contracts in the year which the contract was finally completed and accepted. Having made this election, the taxpayer then erroneously reported income on a contract before it was finally completed and accepted. The Sixth Circuit held that the taxpayer was not bound by its error:

> [T]he principle of election does not apply where the taxpayer has no legal opportunity to choose. If, under the statutes, income must be reported in a certain way and the taxpayer erroneously reports it in a different way, such treatment is not binding upon either the taxpayer or the Commissioner.

296 F.2d at 294 (citations omitted).[13]

In sum, decisions of the Fifth and Ninth Circuits, as well as decisions of the Tax Court, which handles most federal tax litigation,[14] recognize that there is a fundamental difference between a change in accounting procedures and the correction of a substantive error that would be improper under any set of accounting procedures. The Federal Circuit here, in holding to the contrary that it is "irrelevant" whether petitioner's error was improper under any method of accounting, has created an irreconcilable and intolerable conflict. Certiorari should be granted to resolve this conflict.

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[13] *See also North Carolina Granite Corp.*, 43 T.C. at 168 ("[S]ection 446(e) (and its predecessors in the regulations) is not applicable where the law specifically prescribes or proscribes a method of accounting or computation; the general requirement of consent to change yields before the more specific commands of the law.") (citing, *inter alia, Thompson-King-Tate*).

[14] The Tax Court has jurisdiction over all cases in which the Commissioner proposes to assess a deficiency against a taxpayer and the taxpayer contests the deficiency. I.R.C. §§ 6211, 6213, 6512. The United States Claims Court has concurrent jurisdiction with district courts over suits for refund. 28 U.S.C. §§ 1346(a)(1), 1491.

II. THE ISSUE HAS WIDESPREAD SIGNIFICANCE.

Certiorari should also be granted because this petition presents an important question concerning the meaning of basic and constantly applied provisions of the Internal Revenue Code. What constitutes a change in method of accounting is an issue that arises in a wide variety of factual contexts under both § 446(e) and § 481, affects all types of taxpayers, and has long been the subject of controversy.[15]

The decision here has the potential for vastly expanding the Commissioner's power. If followed by other courts, the Court of Appeals' conclusion that an improper tax treatment cannot be corrected by a taxpayer without triggering § 446(e) would mean not only that the Commissioner's consent is required to correct the treatment in the year in which the taxpayer initiated it. It also would mean that consent is required to change the treatment in *future* years, and indeed even as to new quantities of the item acquired or produced *after* the erroneous treatment began. The result would be to place at the Commissioner's mercy the taxpayer who makes an inadvertent, good faith error. The Commissioner would have the authority

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[15] In addition to the cases cited in Part I, *supra*, see, *e.g.*, *ESCO Corp.* v. *United States*, 750 F.2d 1466 (9th Cir. 1985); *Knight-Ridder Newspapers, Inc.* v. *United States*, 743 F.2d 781 (11th Cir. 1984); *Witte* v. *Commissioner*, 168 App. D.C. 133, 513 F.2d 391 (1975); *Woodward Iron Co.* v. *United States*, 396 F.2d 552 (5th Cir. 1968); *Broida, Stone & Thomas, Inc.* v. *United States*, 204 F. Supp. 841 (N.D. W.Va.), *aff'd*, 309 F.2d 486 (4th Cir. 1962).

This Court considered an issue similar to that presented here sufficiently important to warrant review in *Pacific National Co.* v. *Welch*, 304 U.S. 191 (1938). In *Pacific National*, the issue was whether a taxpayer that elected one of two permissible methods of reporting income from certain sales of property was bound by the election. This Court held that the taxpayer was bound. *Id.* at 194-95. Here, the issue is whether a taxpayer who makes an error that would be improper under any set of accounting procedures is bound by his error, and can make a correction only if the Commissioner consents.

to withhold his consent to the correction of such an error, and thereby not only pocket mistaken overpayments to the government, but also require the taxpayer to continue the error year after year. Section 446(e) never was remotely intended to vest such far-reaching power in the Commissioner.

The effects of this decision are already visible. The Internal Revenue Service already has begun to take advantage of the new power vested in it by the Federal Circuit by relying on the decision to revoke a revenue ruling that has stood for almost 20 years,[16] and to modify another revenue ruling that had stood for 15 years.[17] Now in its new Rev. Rul. 90-38, 1990-18 I.R.B. 7, the Internal Revenue Service states that a taxpayer that has capitalized interest and other carrying charges under I.R.C. § 266 for two or more consecutive tax years without making a valid election has nonetheless adopted a method of accounting. According to the new ruling, such a taxpayer cannot amend its returns to make a valid election unless it obtains the prior consent of the Commissioner.

As this new Revenue Ruling shows, the Court of Appeals' reading of § 446(e) has the potential for drastically curtailing the long-recognized right to amend tax returns and file claims for refunds. Congress separately provided the right to file suits for refunds, and the exer-

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[16] *See* Rev. Rul. 70-539, 1970-2 C.B. 70. Rev. Rul. 70-539 had held that a corporation that had failed to file a statement identifying items it was capitalizing had not made a valid election under I.R.C. § 266 and therefore could treat the items as current operating expenses on its amended tax returns.

[17] *See* Rev. Rul. 75-56, 1975-1 C.B. 98. Rev. Rul. 75-56 had held that a taxpayer cannot amend its returns to deduct erroneously capitalized expenses if the period for amending the first return reflecting the capitalized expenses has expired. Rev. Rul. 90-38, 1990-18 I.R.B. 7 modifies it to eliminate any inference that the statute of limitations must expire before the taxpayer has adopted a method of accounting under § 266. As modified, it is revoked as obsolete.

cise of that right has been made conditional on the filing of claims for refunds, *i.e.*, amended tax returns. I.R.C. §§ 6511, 7422; Treas. Reg. § 301.6402-3. In light of the complexity of the Internal Revenue Code, the right to amend a return is critically important. Until this case, it had been understood that § 446(e) restricted the right to amend a return only insofar as a taxpayer sought to change an accounting procedure. By extending § 446(e) to any correction of a substantive error that would affect the time for reporting an item, the Court of Appeals has expanded that provision enormously, at the expense of the right to amend a return. The Court of Appeals' ruling threatens to prevent thousands of taxpayers from correcting common errors in the tax treatment of items until such time as the Commissioner grants his consent, and threatens to lessen public confidence in the rationality and consistency of the tax law.

CONCLUSION

For the foregoing reasons, certiorari should be granted.

Respectfully submitted,

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June 22, 1990

APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

No. 89-1349

DIEBOLD, INCORPORATED,
Plaintiff-Appellant,

v.

THE UNITED STATES,
Defendant-Appellee.

December 19, 1989

Before BALDWIN and FRIEDMAN,* Senior Circuit Judges, and MAYER, Circuit Judge.

MAYER, Circuit Judge.

OPINION

Diebold, Inc. appeals the judgment of the United States Claims Court, 16 Cl.Ct. 193 (1989), that, because Diebold changed its method of accounting without the Commissioner's prior consent as required by section 446(e) of the Internal Revenue Code of 1954, 26 U.S.C. § 446(e) (1982), it was not entitled to a refund of income taxes. We affirm.

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* Judge Friedman took senior status on November 1, 1989.

BACKGROUND

Neither party suggests that summary judgment was inappropriate. Therefore, we adopt the Claims Court's statement of undisputed facts and recount only those necessary to our discussion.

Diebold, an accrual basis taxpayer, manufactures and sells automated teller machines (ATMs). To facilitate on-site repair, it designed its ATMs in modular form: an ATM is composed of several modules, each of which performs a different function, such as reading magnetic cards, accepting deposits, dispensing cash, printing receipts and transmitting customer commands. Diebold maintains a pool of replacement modules so that when a customer's ATM needs repair, Diebold can rapidly restore it to service by replacing the malfunctioning module with a spare from its pool. The defective module is then repaired and put into the pool. Diebold maintains these replacement modules were never held for sale and were installed in its customers' ATMs under service contracts for which there was an annual fee, but no separate charge for the replacement modules.

In Diebold's original tax returns for 1976 and 1977, it claimed no investment tax credit or depreciation for the cost of manufacturing its set of replacement modules. Instead, they were considered nondepreciable inventory for which there was no deduction until they were removed from service. On March 31, 1980, however, Diebold wrote a letter to the Internal Revenue agent who was auditing its 1976 and 1977 returns, explaining that the replacement modules should be treated as depreciable property to clearly reflect taxable income, and requesting that the agent take this change into account. Believing this to be an informal claim for a refund, the auditor requested that Diebold file amended returns to formalize the claim. Diebold complied and filed amended returns on October 3, 1980 for these tax years, claiming both a

depreciation deduction and an investment tax credit for the replacement modules, giving rise to a refund. By letter dated April 18, 1983, the regional commissioner disallowed the claims for refund, and Diebold filed this suit in the Claims Court.

In granting summary judgment for the government, the Claims Court held that Diebold was not entitled to a refund because it did not secure the consent of the Commissioner before changing its method of accounting, as required by section 446(e) of the Internal Revenue Code and Treasury Regulation § 1.446-1(e). This judgment was based on the fact that Diebold had consistently accounted for the replacement modules as inventory during the tax years in question, and then sought, by way of amended returns, to treat them as depreciable assets without having filed the required Form 3115 to request the Commissioner's consent to the change.

DISCUSSION

Diebold tells us it did not change its method of accounting within the meaning of section 446(e) of the Internal Revenue Code, but simply corrected an error in the application of a pre-existing method of accounting by filing amended tax returns for the years going back to the first year in which the mistake was made. But we believe the Claims Court was correct that Diebold's claim for refunds was based on an impermissible change in the method of accounting on the basis of which Diebold regularly computed its taxable income within the meaning of section 446(e) and Treasury Regulation § 1.446-1(e). The relevant texts of these provisions are set out in the margin.[1]

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[1] Section 446(e). *Requirement respecting change of accounting method.* Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books

The argument that Diebold sought merely to correct a "posting error" by shifting the rotatable pool of replacement modules from the inventory account to the pre-existing capital account is not persuasive. In contrast to the cases it relies on, *e.g., Gimbel Bros. v. United States,* 535 F.2d 14, 210 Ct.Cl. 17 (1976), *later proceeding,* 211 Ct.Cl. 383 (1976); and *Standard Oil Co. (In-*

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shall, before computing his taxable income under the new method, secure the consent of the Secretary.

Treas.Reg. § 1446-1. General rule for methods of accounting.

(e) *Requirement respecting the adoption or change of accounting method.* (1) A taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. . . .

(2)(i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder.

(ii)(A) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories. . . .

(3)(i) Except as otherwise provided under the authority of subdivision (ii) of this subparagraph, in order to secure the Commissioner's consent to a change of a taxpayer's method of accounting, the taxpayer must file an application on Form 3115 with the Commissioner of Internal Revenue, Washington, D.C. 20224, within 180 days after the beginning of the taxable year in which it is desired to make the change.

diana) v. Commissioner, 77 T.C. 349 (1981),[2] Diebold does not seek to account for the replacement modules in the same manner that it accounts for other similar items or to correct the omission of an item from a method of accounting that it otherwise consistently applies to a single category of related items. In *Gimbel Bros.*, the taxpayer sought to change from the accrual method to the installment method of reporting the income from its rotating charge accounts. The court found that these accounts had "substantially similar characteristics" to other charge accounts that the taxpayer already reported on the installment method. 535 F.2d at 15 n. 2, 22. In *Standard Oil Co.*, the court characterized the taxpayer's error simply as a "failure to report similar items consistently under a fixed method of accounting". 77 T.C. at 383.

Here, there is no assertion, nor can there be, that Diebold's replacement modules are similar to or in the same category as other items in the capital asset account. In fact, Diebold accounted for replacement modules as nondepreciable inventory in 1974 and 1975, years for which it claimed no refund. 16 Cl.Ct. at 195. Similarly, Diebold accounted for spare parts for its physical security equipment (another line of business) in its inventory account.

Diebold also relies on *Korn Industries, Inc. v. United States*, 532 F.2d 1352, 209 Ct.Cl. 559 (1976), in support of its "posting error" argument, but this case is also different from ours. There, the taxpayer mistakenly omitted three materials costs from the calculation of the cost of finished goods in inventory. These three elements of cost were included, however, in the raw materials in-

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[2] *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697 (10th Cir.1955), also relied upon by Diebold, was decided under section 41 of the 1939 Code, which is significantly different from its successor, section 446(e) of the 1954 Code, and is distinguishable. *See* 16 Cl.Ct. at 201.

ventory, the work-in-progress inventory and the supplies inventory. Therefore, it was obvious that the taxpayer had established the omitted items as materials costs and that it had merely made a posting error when it left them out of the calculation of the cost of finished goods in inventory. In contrast, Diebold has established the inventory method of accounting for the replacement modules and seeks to change to a different method by treating the modules as depreciable assets rather than as inventory. The argument that it seeks to correct a substantive error independent of its choice of accounting procedures is simply wrong.

It is not clear that Diebold's original tax treatment of its replacement modules was improper. However, even if it were correcting an erroneous characterization of the replacement modules, the correction would still be considered a change in the method of accounting. Treas. Reg. § 1.446-1(e)(2)(i); *see Witte v. Commissioner*, 513 F.2d 391, 394 (D.C.Cir.1975); see also cases cited by the Claims Court, 16 Cl.Ct. at 201. Therefore, Diebold's argument that the replacement modules were not held for sale and consequently could not properly be treated as inventory under any accounting method is irrelevant.

The Claims Court was correct that the change from inventory to depreciation treatment of the replacement modules was "a change in the treatment of [a] material item" because it "involves the proper time for the inclusion of the item in income or the taking of a deduction". Treas.Reg. § 1.446-1(e)(2)(ii)(a). Diebold's counter that it did not and could not have taken a deduction for the cost of inventory and therefore that the change does not involve the timing of a deduction does not wash.

First of all, there is no question that a change from treating the replacement modules as nondepreciable inventory, where there is no deduction until the modules are removed from service, to treating them as capital

assets, where there is a depreciation deduction in each year of useful life, raises the question of the taxable year in which income is reduced by the cost or a portion of the cost of manufacturing the replacement modules, that is, a question of timing. Besides that, the definition of "a material item" is not limited to the technical meaning of a "deduction", excluding a change in the timing of items, such as the cost of goods sold, that enter into the calculation of gross income. The definition, which also includes "item[s] in income", is broad enough to comprehend the timing of subtractions from gross receipts, especially where the new method of accounting unquestionably involves a deduction in its technical sense. *See, e.g., Hooker Indus., Inc. v. Commissioner*, 44 T.C.M. (CCH) 258, 267 (1982) (section 446 (e) applies to a change from deducting the cost of supplies when used to expensing the items when purchased). So narrow a construction of the term "material item" would shift the focus of the definition from the timing of the inclusion or exclusion of items in or from income to the technical nature of the inclusions or exclusions themselves.

Diebold was required to obtain the Commissioner's consent even though it sought to amend its tax returns back to 1976, which Diebold asserts is the first year in which it maintained a pool of replacement modules for installation in customers' ATMs under its full service contracts. *See Southern Pacific Transp. Co. v. Commissioner*, 75 T.C. 497, 682 (1980) (". . . consent is required when a taxpayer . . . retroactively attempts to alter the manner in which he accounted for an item on his tax return"). Section 446(e) prohibits taxpayers from unilaterally amending their tax returns simply because they have discovered that a different method of accounting yields a lower tax liability than the method they originally chose.

It is for the Commissioner to determine whether a change in a taxpayer's method of accounting results in

the omission of items from income or in the doubling or "bunching" of deductions or exclusions and to make compensating adjustments. Even if the chosen method of accounting caused a mismatching of income and deductions, Diebold could not change it without first obtaining the Commissioner's consent. It was Diebold's duty to bring a request to the Commissioner's attention by filing Form 3115 so he could determine whether the change would result in a distortion of income.

Finally, Diebold here claims that, even if it was required to file Form 3115 to obtain the Commissioner's consent, he waived the requirement by considering the merits of the change Diebold wished to make after being fully apprised of its request. In the Claims Court, Diebold said the Commissioner actually consented to a change of accounting method, but it did not clearly raise the waiver argument. At best, it was only indirectly alluded to in the middle of oral argument on a different issue. We will not decide an issue that was not squarely presented to the trial court. "We can hardly hold . . . that the [trial] court did or did not err in resolving issues it did not resolve and those it had no opportunity to resolve." *Black & Decker, Inc. v. Hoover Serv. Center*, 886 F.2d 1285, 1289, 12 USPQ2d 1250, 1254 (Fed.Cir. 1989). We think the proposition dubious in any event because, although the technical requirement of filing Form 3115 might be waived, under section 446(e) consent of the Commissioner must be secured before changing a method of accounting. "[E]xplicit statutory requirements . . . are beyond the dispensing power of Treasury officials." *Angelus Milling Co. v. Commissioner*, 325 U.S. 293, 296, 65 S.Ct. 1162, 1164, 89 L.Ed. 1619 (1944).

CONCLUSION

Accordingly, the judgment is affirmed.

AFFIRMED.

APPENDIX B

UNITED STATES CLAIMS COURT

No. 374-83T

DIEBOLD, INCORPORATED,
Plaintiff,
v.

THE UNITED STATES,
Defendant.

January 18, 1989

OPINION

RADER, Judge.

In this tax refund action, the plaintiff, Diebold, Inc. (Diebold), seeks a refund of federal income taxes in the amounts of $454,261 for taxable year 1976 and $350,509 for taxable year 1977. The plaintiff claims that, in those years, it was entitled to both a deduction for depreciation and an investment tax credit on replacement parts for automatic electronic banking units. The plaintiff maintained these parts in a service pool and only placed them in service when necessary to replace a defective part in a customer's automatic banking unit. From 1976 through 1979, the plaintiff accounted for these parts as inventory on its tax returns. The cost of goods in inventory cannot generally be deducted until those goods are sold or are no longer serviceable. At that point, the cost of producing the inventory goods is written off against the gross income derived from sales. *Commissioner v. Van Raden*, 650 F.2d 1046 (9th Cir. 1981).

In 1980, the plaintiff filed amended returns that accounted for the replacement parts as depreciable capital assets. By treating them as capital assets, the plaintiff could deduct the cost of producing the parts ratably over their entire useful life. Moreover, the plaintiff could claim an investment tax credit. The difference between inventory treatment and capital asset treatment of the parts is represented by the amounts the plaintiff claims as a refund in this suit.

Based on these same undisputed facts, the defendant has filed for summary judgment. The defendant contends that the Internal Revenue Code requires a taxpayer to secure the Commissioner's consent prior to changing from one accounting method to another. Internal Revenue Code, 26 U.S.C. § 446(e) (1982 & Supp. IV 1986). Because the plaintiff failed to secure the Commissioner's consent prior to changing accounting methods, the defendant contends that it is entitled to judgment as a matter of law.

After argument, this court grants the motion of the United States. Accordingly, the complaint is to be dismissed.

FACTS

Unless otherwise noted, the following facts are undisputed. The plaintiff, Diebold, Inc., (Diebold), is an accrual-basis taxpayer whose primary business is marketing bank security systems. In the early 1970's, Diebold entered the automated teller machine (ATM) market. At first, the plaintiff sold an ATM assembled from component parts purchased from other manufacturers. Later Diebold began to develop its own more sophisticated teller machines.

The plaintiff designed and built an "A" series ATM in 1974. After refinements, Diebold began to market a "B" series ATM. Both of these early series were prone to malfunction. However, series "C," which Diebold began to produce in July 1975, was a considerable improvement. Accordingly, the plaintiff's sales increased.

Diebold designed and built the new series "C" ATMs in modular form. Each machine comprised separate subassemblies (modules) to perform distinct functions, such as reading magnetic cards, accepting deposits, dispensing cash, printing receipts, or transmitting customer commands.

Diebold's innovative modular system facilitated immediate on-site repair of a malfunctioning machine. To restore ATM service as quickly as possible, Diebold's service personnel carried spare replacement modules when making a service call. If unable to repair a disabled machine in a few minutes, the plaintiff's service personnel simply replaced the faulty part with a spare module from the service pool. With a functional module in place and service restored, Diebold shipped the faulty module to a central repair facility. After repair, the rehabilitated module was returned to the service pool for use as a replacement part in another malfunctioning ATM. These service modules were "rotated" in the sense that malfunctioning parts were repaired and returned to the pool of spare replacement parts. The plaintiff's pool of service modules, though constantly rotating, remained fairly constant in size.

In 1975, Diebold decided to convert the unreliable "A" and "B" model ATMs that had been previously installed in customer premises into functional "C" units. The plaintiff hoped thereby to improve customer relations, enhance marketing, and reduce service costs. In 1975, the plaintiff converted 58 of its 88 "A" and "B" units into reliable "C" units. Throughout this period, the retrofitting or conversion operation was entirely separate from the service rotation program. The plaintiff estimated that the cost of completing the conversion in 1976 would be $687,300 and included that amount in its 1975 tax return as a cost of goods sold.

Meanwhile the plaintiff deducted (in 1974 and 1975), as start-up costs, the engineering expenses attributable to

development of "C" model hardware. The plaintiff claimed that these research and development (R & D) expenses totalled $306,400 in 1974 and $413,600 in 1975.

The Internal Revenue Service (IRS or Service) audited Diebold's 1974 and 1975 returns, ultimately challenging the plaintiff's 1975 deduction for conversion costs actually incurred in 1976. The IRS also disallowed Diebold's 1974 and 1975 deductions for engineering expenses, contending that those expenditures created an intangible asset amortizable over five years. The plaintiff maintained that the 1976 conversion costs were properly accrued in 1975 and that the engineering costs of developing "C" model hardware were deductible as an R & D expense.

On December 6, 1979, the plaintiff and the IRS settled this dispute. Under the settlement agreement, Diebold was permitted to deduct one-half of the 1976 conversion costs in 1975 (and the other half in 1976), but was required to depreciate the engineering costs according to the IRS proposal. The settlement agreement terminated the controversy over Diebold's tax treatment of the retrofitting program.

Although the rotation and retrofitting programs employed entirely separate accounting and management systems, these negotiations over treatment of retrofitting modules suggested to Diebold the benefits of a different tax treatment for rotating service modules. As early as 1974, Diebold accounted for the spare service modules as nondepreciable inventory in both tax returns and financial reports. Diebold clearly adopted this inventory accounting treatment in its tax returns for the years 1976, 1977, 1978, and 1979. The settlement negotiations on retrofitting modules, which concluded in December 1979, made evident to Diebold the benefits of depreciating the rotating service modules.

Diebold's original Form 1120 (Corporation Income Tax Return) for 1976 was filed on June 15, 1977. The return

showed a tax due of $5,404,013, which the plaintiff immediately paid. Diebold's 1976 return did not claim any investment tax credit for the costs ($3,069,327) of manufacturing rotatable service modules. Nor did the plaintiff claim any depreciation. Instead, Diebold accounted for the spare modules as nondepreciable property without a determinable life. Hence, the plaintiff counted receipts from its service contracts as income and deducted the cost of providing service.

Plaintiff filed its original 1977 return on June 5, 1978, and paid the $3,545,343 reported due. As in 1976, the plaintiff treated replacement modules as inventory. The plaintiff claimed no depreciation for service modules in its original 1977 tax return.

In the wake of the retrofitting module settlement, Diebold began to list these replacement modules as depreciable assets in its 1980 return and in financial statements. On October 6, 1980, plaintiff filed amended returns for the years 1976, 1977, and 1978, and 1979. In the amended returns, Diebold changed its tax accounting treatment of spare service modules from inventory to depreciable property eligible for the investment tax credit. Accordingly, Diebold claimed a refund for 1976 of $454,261 and for 1977 of $350,509. At the time it filed these amended returns, Diebold's 1976 and 1977 returns were being audited by the IRS.

The Service on April 18, 1983 disallowed plaintiff's 1976 and 1977 refund claims, maintaining that Diebold was not entitled to change unilaterally its method of accounting. After Diebold treated spare parts as inventory for several years, the Service asserted that Diebold was required to secure the consent of the Commissioner of Internal Revenue (Commissioner) prior to changing accounting methods. The plaintiff did not file Form 3115 (request for Commissioner's consent to change accounting method) prior to attempting to amend its returns and apparently has not filed such form to date.

Each of the plaintiff's amended returns (1976, 1977, 1978, and 1979) and refund claims was based upon a change in accounting method, effected in 1980 and beginning with the amended return for 1976. For reasons that remain unclear, the Service acted upon plaintiff's 1979 amended return and refund request prior to those for 1976, 1977, and 1978. Diebold's Form 1120X (Amended Corporate Tax Return) for 1979 stated that the "change in the deductions was due to an error." The amended 1979 return did not disclose that plaintiff had originally treated its spare parts, in respect to which it now claimed deductions and credits, as inventory. Like the first 1976 and 1977 returns, Diebold's original return for 1979 claimed no depreciation deductions or investment tax credit with respect to spare service parts.[1]

On February 2, 1981, two years before disallowing the plaintiff's 1976 and 1977 claims, the IRS sent Diebold notice that its refund for 1979 had been allowed in the amount of $775,269. On April 18, 1983, defendant denied the 1976 and 1977 claims. On September 13, 1984, the Service issued a 30-day letter denying Diebold's 1979 refund. The Service apparently has not yet taken action on plaintiff's 1978 amended return.

The plaintiff filed its complaint in this court challenging the Service's April 18, 1983, disallowance of the refunds requested for tax years 1976 and 1977.

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[1] The parties stipulate that the original returns for 1976, 1977, and 1978 had not claimed these deductions and credits because the plaintiff treated spare modules as inventory. The parties also stipulate that the plaintiff's 1976, 1977, and 1978 amended returns were identical in pertinent part to the amended return for 1979. None of the amended returns disclosed the change of accounting treatment.

DISCUSSION

Pursuant to RUSCC 56(b), the United States moves for summary judgment asserting the absence of any genuine issue of material fact and claiming entitlement to judgment as a matter of law. Summary judgment is an integral part of the rules of this court which are designed "to secure the just, speedy, and inexpensive determination of every action." RUSCC 1(a)(1); *see also Celotex Corp. v. Catrett*, 477 U.S. 317, 327, 106 S.Ct. 2548, 2555, 91 L.Ed.2d 265 (1986). RUSCC 56 enables the court to dispose efficiently of cases as a matter of law when no material controversy of fact remains. Thus, the rule permits the court to streamline the judicial process by isolating and disposing of factually unsupported claims or defenses. *Celotex*, 477 U.S. at 323-24, 106 S.Ct. at 2553-54.

To attain these judicial economies, the rule allows the court to pierce the factual allegations in the pleadings and reach a legal resolution when more evidence than is already available in connection with the motion for summary judgment could not reasonably be expected to change the legal result. *Pure Gold v. Syntex (U.S.A.), Inc.*, 739 F.2d 624, 626 (Fed.Cir.1984).

In this case, the factual evidence contained in the oral and written presentations of the parties was considered under the standards enunciated in *Adickes v Kress*, 398 U.S. 144, 90 S.Ct. 1598, 26 L.Ed.2d 142 (1970), and *Celotex*. These cases establish the burdens to be borne by the movant and opponent of a summary judgment motion. *Adickes* governs the movant's obligations under the summary judgment rule. A movant for summary judgment has the "burden of showing the absence of a genuine issue as to any material fact. . . ." *Adickes*, 398 U.S. at 157, 90 S.Ct. at 1608. The subsequent *Celotex* decision, however, clarifies that the *Adickes* rule does not require the movant to produce evidence showing the absence of a genuine issue of material fact with respect to an issue

on which the nonmoving party bears the burden of proof. In such a case, the movant's burden may be discharged by demonstrating an absence of evidence to support the nonmoving party's case.

Celotex obliges a party to "make a showing sufficient to establish the existence of [every] element essential to the party's case, and on which that party will bear the burden of proof at trial." 477 U.S. at 322, 106 S.Ct. at 2552. Thus, a complete failure of proof concerning an essential element of the nonmoving party's case entitles the moving party to judgment as a matter of law. *Id.* at 323, 106 S.Ct. at 2553.

United States v. Diebold, Inc., 369 U.S. 654, 82 S.Ct. 993, 8 L.Ed.2d 176 (1962), provides instruction concerning the weight to be given the presentations of each party: "On summary judgment the inferences to be drawn from the underlying facts contained in such materials must be viewed in the light most favorable to the party opposing the motion." *Id.* at 655, 82 S.Ct. at 994. When evaluating the merits of the motions, the court must resolve reasonable factual disputes against the movant. *Schwabenbauer v. Board of Education*, 667 F.2d 305, 313-14 (2d Cir.1981). Mere denials or conclusory statements, however, are not sufficient to create an evidentiary conflict. *Barmag Barmer Maschinenfabrik AG v. Murata Machinery, Ltd.*, 731 F.2d 831, 836 (Fed.Cir. 1984).

A material fact is one which will make a difference in the result of a case. *Curtis v. United States*, 144 Ct.Cl. 194, 199, 168 F.Supp. 213, 216 (1958), *cert. denied*, 361 U.S. 843, 80 S.Ct. 94, 4 L.Ed.2d 81 (1959). Substantive law provides the basis to identify the material facts. Only disputes over facts that might affect the outcome of the suit will properly preclude an entry of judgment. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248, 106 S.Ct. 2505, 2510, 91 L.Ed.2d 202 (1986).

I. *Consent requirements*

Defendant has moved for summary judgment asserting that plaintiff attempted to "change its method of accounting for certain rotatable spare service parts without having properly requested or obtained the consent of the Commissioner." Def's Brief filed March 17, 1987, at 1. The uncontroverted facts, construed to resolve doubts in favor of the plaintiff, indicate that Diebold changed from an inventory accounting method for spare service modules to a depreciation method without obtaining the required consent.

The Internal Revenue Code sets forth the consent requirement governing changes in accounting method:

> *Requirement Respecting Change of Accounting Method.*—
>
> Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary.

26 U.S.C. § 446(e).

Treasury Regulations further clarify the foregoing Code requirements:

> (e) *Requirement respecting the adoption or change of accounting method.* (1) a taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. . . .
>
> (2) (i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner.

Consent must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder.

(ii) (a) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions *or a change in the treatment of any material item used in such overall plan.* Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. *A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction.* Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder). . . .

(3) (i) Except as otherwise provided under the authority of subdivision (ii) of this subparagraph, in order to secure the Commissioner's consent to a change of taxpayer's method of accounting, *the taxpayer must file an application on form 3115. . . .*

26 C.F.R. § 1.446-1(e) (1988) (emphasis added).

Thus, to briefly restate the requirements of the statute as interpreted by the regulations, taxpayer intending to change any method of regularly computing income on any material item must first obtain the consent of the Secretary of Treasury. A material item, according to the regulations, is any item involving the timing of computing income or deductions.

The Court of Claims applied this rule in a 1965 case where the taxpayer attempted to switch from a strict

cash basis of accounting to a hybrid of accrual and cash basis accounting:

> The possibility that taxpayers might wish to change their systems of accounting from time to time was contemplated, and a procedure whereby such changes might be effected was prescribed. . . .
>
> . . . .
>
> Therefore, if the plaintiff desired to change its treatment . . . the plaintiff had the privilege of applying to the Commissioner of Internal Revenue for permission to make such a change. . . .
>
> . . . .
>
> The reason for the exercise of such discretionary power by the Commissioner was that a change in the method of reporting an important item of expense or of income would almost certainly result in some distortion of net income . . . and it was incumbent upon the Commissioner to see that such distortion was not unduly detrimental to the revenue of the Government.

Hackensack Water Co. v. United States, 173 Ct.Cl. 606, 612-13, 352 F.2d 807 (1965).

As a matter of uncontroverted fact, Diebold did consistently account, over a period of at least four years (tax years 1976-79), for its replacement modules as inventory. In 1980, the plaintiff sought by amended return to treat the modules instead as noninventory depreciable assets eligible for the investment tax credit. A "change," from inventory to depreciation treatment constituted a "change in the method of accounting" within the meaning of the Code and the Treasury Regulations. This term, according to Treasury Regulations, is defined as "a change in the treatment of any material item." A "material item," in turn, is defined as "any item which involves the proper time for the . . . taking of a deduction." 26 C.F.R. § 1.446(e)(2)(ii)(a).

In this case, the plaintiff's attempt to claim depreciation (over a five-year useful life) on rotatable spare parts involves the proper time for the taking of a deduction. Diebold initially treated its spare modules as inventory, a method that permits the cost of acquiring inventory to be deducted in a single year.[2] Diebold's amended returns, in contrast, seek to recover the cost of the spares ratably over their useful life. *See* 26 U.S.C. § 167. By plaintiff's own figures, the accounting treatment it proposes by amended return would generate $9,110,913 more in deductions (all at an earlier time) than would its original (inventory) treatment, for the period 1976-1982 alone.

According to applicable law, as well, the plaintiff's amended return involves the proper time for the taking of a deduction. *See, e.g., Southern Pac. Transp. Co. v. Commissioner*, 75 T.C. 497, 680-83 (1980), *supp. op.* 82 T.C. 122 (1984) (change in depreciating certain assets affected time of deduction and was change of accounting method); *Hooker Industries, Inc. v. Commissioner*, T.C. Memo. (P-H) ¶ 82,357, at 1546-47 (1982) (change from deducting cost of inventory at time of use to deducting inventory at time of purchase was a material item). These cases establish that changes within inventory or depreciation techniques, let alone a change from inventory to depreciation, involve the timing of deductions.

Because shifting from inventory to depreciation clearly involves the proper time for the taking of a deduction—a point which the plaintiff virtually concedes, Pl. Findings at ¶¶ 30, 31, 40, 56—Diebold's amended return changed accounting methods for a "material item."

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[2] Inventory accounting normally requires inclusion of the cost of additions to inventory during a given year in the cost of opening inventory. Deducting the cost of closing inventory from this figure yields the cost of goods sold. Such cost is deducted from gross revenues from sales to compute gross profits.

Therefore, the threshold requirements for the application of the consent rule have been satisfied. *Witte v. Commissioner*, 513 F.2d 391, 393 (D.C.Cir.1975).

Thus, § 446(e) requires the Commissioner's consent prior to such a change, and 26 C.F.R. § 1.446-1(e)(3)(ii) prescribes the method for securing that consent. The plaintiff admits that it did not file an application for consent on Form 3115 as the regulation requires. Declaration of Lyman Friedman, February 20, 1987, Def. Br. filed March 17, 1987, App. C, at A-165. (Bricken Declaration). The requirement of Form 3115 is also established by case law. *See, e.g., Southern Pac. Transp.*, 75 T.C. at 682; *Casey v. Commissioner*, 38 T.C. 357, 385-86 (1962); *Advertisers Exchange, Inc. v. Commissioner*, 25 T.C. 1086, 1093 (1956), *aff'd per curiam*, 240 F.2d 958 (2d Cir. 1957).

While not contesting these material facts, the plaintiff opposes the defendant's summary judgment motion on three alternative grounds. First, Diebold argues that the Commissioner's approval was not required. The plaintiff makes three alternative contentions in support of this argument: (1) Its conduct fits within an exception in § 446(e) because the plaintiff merely corrected an accounting error; (2) § 446(e) does not govern because the plaintiff had not "regularly" used its original accounting method; and (3) its amended returns do not interfere with the purposes underlying the consent rule of § 446(e). Second, Diebold argues that even if consent was required it was, directly or indirectly, granted. Third, Diebold takes the position that, if neither of the arguments above prevail, there are still substantial unresolved issues of material fact requiring full evidentiary hearings.

II. *Not a correction, but a change*

The plaintiff first contends that its amended return treatment of spare parts fits within an exception to the § 446(e) regulation, which states that "[a] change in method of accounting does not include correction of

mathematical or posting errors. . . ." 26 C.F.R. § 1.446.1 (e)(2)(ii)(b). Diebold maintains that its amended return corrected an "erroneous application of inventory method of accounting" and consequently did not require consent. Pl.Br. filed May 29, 1987, at 26. This argument fails because the plaintiff changed methods of accounting, rather than simply correcting the "mathematics or posting" of its original accounting system. In other words, the plaintiff would be allowed, without securing IRS approval, to correct mathematical or posting errors in the figures generated by its original inventory accounting method. Instead, the plaintiff changed from inventory accounting to depreciation accounting—a change which involved the timing of deductions. By definition, this change required consent.

The regulations also highlight the distinction between corrections and changes by clarifying that "a change in method of accounting does not include adjustment of any item of income or deduction which does not involve the proper time for . . . the taking of a deduction." 26 C.F.R. 1.446-1(e)(2)(ii)(b). If, therefore, the plaintiff's amended return merely corrected or adjusted items which did not involve deduction timing, consent would not be required. Diebold's 1980 attempt to amend the 1976 and 1977 returns, however, drastically altered deduction timing.

Construing the facts favorably to the plaintiff, Diebold in 1980 proposed to change from an incorrect accounting method to a correct accounting method without obtaining consent.[3] Correcting an error in the selection of account-

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[3] Defendant does not concede that the plaintiff's original inventory treatment, although not as beneficial to the plaintiff, was incorrect. In argument counsel for the defendant clarified the Government's position:

> THE COURT: . . . if I understand you correctly, you do feel these rotatable modules are appropriately classified as inventory and not depreciable assets.
>
> MR. BASSIN: Right.

ing methods, however, is not exempted from the consent requirement. In the first place, the words of the Tax Code state clearly that "[e]*xcept as otherwise expressly provided in this chapter*, a taxpayer who changes the method of accounting . . . shall . . . secure the consent of the Secretary." 26 § U.S.C. 446(e) (emphasis added). Thus, Congress provided that the only exceptions to the consent rule would be expressly stated in the Code.[4] The effect of this statutory language, therefore, is to make any change in accounting method, except those specifically excluded by statute or regulation, comply with the prior consent rule.

Moreover, the language of the applicable regulation is unequivocal: "[c]onsent [to change methods] must be secured *whether or not* such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder." 26 C.F.R. § 1.446-1(e)(2)(i) (emphasis added). The examples given in the regulation further illustrate that consent is required even where the taxpayer changes from an incorrect method to a correct one. 26 C.F.R. § 1.446-1(e)(2)(iii) examples 6-8.

Most federal courts faced with the question have enforced the consent rule without taking into consideration the correctness of the original method. The Court of Claims has enforced the consent rule despite the taxpayer's desire to change from an incorrect to a correct method of accounting. *Ed Smithback Publishing, Inc. v. United States*, 37 A.F.T.R.2d 76-486, 76-495 (1975) (decision of Trial Judge Lydon), *adopted mem.*, 209 Ct.Cl. 743, 538 F.2d 347 (1976). Similarly, the United States

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[4] The exceptions clause in § 446 is found in subsection (b). *See infra* note 6 and accompanying text. This exception governs instances when the taxpayer has not regularly used a method of accounting or has not used a method clearly reflective of income. In those instances, the general rule permitting use of the taxpayer's regular accounting method is replaced with a provision allowing the Secretary to select a method that does reflect income. 26 U.S.C. § 446(b).

Court of Appeals for the D.C. Circuit ruled that "[t]he danger of distortion of income detrimental to governmental revenues exists regardless of whether the change in method is from one proper method to another or from an improper method to a proper one." *Witte*, 513 F.2d at 394. In addition to the Court of Claims and the District of Columbia Circuit, the consent requirement has been applied regardless of the taxpayer's desire to correct methods by the Second Circuit, *American Can Co. v. Commissioner*, 317 F.2d 604, 606 (2d Cir.1963) *cert. denied*, 375 U.S. 993, 84 S.Ct. 632, 11 L.Ed.2d 479 (1964); the Third Circuit, *Commissioner v. O Liquidating Corp.*, 292 F.2d 225 (3d Cir.), *cert. denied*, 368 U.S. 898, 82 S.Ct. 177, 7 L.Ed.2d 94 (1961); *Poorbaugh v. United States*, 423 F.2d 157, 163 (3d Cir. 1970); the Fourth Circuit, *Broida, Stone & Thomas, Inc. v. United States*, 204 F.Supp. 841, 843 (N.D. W.Va.), *aff'd per curiam*, 309 F.2d 486 (4th Cir.1962); the Fifth Circuit, *Wright Contracting Co. v. Commissioner*, 316 F.2d 249 (5th Cir.1963), *cert. denied*, 375 U.S. 879, 84 S.Ct. 147, 11 L.Ed.2d 110 (1963); and the Ninth Circuit, *United States v. Kleifgen*, 557 F.2d 1293, 1297 n. 9 (9th Cir. 1977).

One circuit court opinion appears to take a contrary position. In 1955, the Tenth Circuit held that "a taxpayer may, without the consent of the Commissioner, apply the method of accounting which he has adopted, though not theretofore applied to a particular item, when that change will correct errors and clearly reflect his income." *Beacon Pub. Co. v. Commissioner*, 218 F.2d 697, 702 (10th Cir.1955). This single divergence from the general rule is explained, however, by the statutory history of § 446(e). *Beacon* was decided under the predecessor to § 446 of the 1954 Tax Code, § 41 of the 1939 Code. Section 41 stated:

> The net income shall be computed . . . in accordance with the method of accounting regularly em-

> ployed in keeping the books of said taxpayer; but if no such method of accounting has been so employed, or *if the method employed does not clearly reflect the income*, the computation shall be made in accordance with such method as in the opinion of the Commissioner does *clearly reflect the income*.[5]

Act of May 28, 1938, ch. 289 § 41, 52 Stat. 473 (current version at 26 U.S.C. § 446) (emphasis added).

The Tenth Circuit explained that "[t]he obvious purpose of these provisions is to obtain from the taxpayer a return reflecting its true income and to treat income received and deductible disbursements consistently." *Beacon*, 218 F.2d at 699. Accordingly, the Tenth Circuit ruled that taxpayer's change in methods accurately reflected his income despite the Commissioner's contrary opinion. Thus, § 41 of the 1939 Code contained no express prior consent rule. Instead, net income was to be computed according to a method that, in the Commissioner's opinion, clearly reflected income. The 1939 provision demanded no prior consent and placed particular emphasis on establishing a method that accurately reflected income. *Id.* at 701-02.

The 1954 revision of the Tax Code changed the legal focus of this section. In the event of a change in accounting methods, the 1954 Code established a prior consent requirement. The correctness of the original return,

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[5] This language may be traced back to § 212 of the Act of 1918. W.E. Barton & C.W. Browning, 1 *Barton's Federal Tax Laws Correlated* 72 (1925). Prior to the 1918 amendments, the comparable section read:

> An Individual keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect his income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of Treasury, make his return upon the basis upon which his accounts are kept. . . .

Id. at 73.

which governed consideration of changes in accounting methods under the 1939 Code, became in 1954 an exception to § 446.[6] Under the 1954 Code, federal courts have consistently required accounting method changes to meet the prior consent requirement without regard to which method more accurately reflects the taxpayer's income. *See, e.g.*, *Witte*, 513 F.2d at 394; *American Can*, 317 F.2d at 606.

The legislative history accompanying enactment of § 446(e) further confirms Congress's intent to require the Commissioner's consent for any changes regardless of which method correctly reflects the taxpayer's income. Identical language in the House and Senate Reports accompanying the Internal Revenue Code of 1954 indicates that "[s]ubsection (e) codifies existing regulations." H.R.Rep. No. 1337, 83d Cong., 2d Sess. A158 (1954); S.Rep. No. 1622, 83d Cong., 2d Sess 300 (1954), U.S. Code Cong. & Admin. News 1954, pp. 4017, 4629. *Bea-*

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[6] Under the 1954 Code, the language from the 1939 Code concerning reflection of income was moved into § 446(b):

> (a) *General rule* Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.
>
> (b) *Exceptions* If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

26 U.S.C. § 446(a) and (b).

The plaintiff makes no written or oral contention that its conduct fits within the exception clause found in § 446(b). Instead, the plaintiff contends that consent under § 446(e) was either unnecessary or already granted.

Under the 1954 Code, the Commissioner's discretion, under § 446(b), to require a taxpayer to employ a method more reflective of actual income will only be set aside by courts in instances of clear abuse. *Cole v. C.I.R.*, 586 F.2d 747 (9th Cir.) *cert. denied*, 441 U.S. 924, 99 S.Ct. 2034, 60 L.Ed.2d 398 (1978).

con, which ruled against requiring the Commissioner's consent, construed the pre-1954 regulations to state that a taxpayer "cannot change its system of accounting without the consent of the Commissioner. Treasury Regulations 111, Sec. 29.14-2." *Beacon*, 218 F.2d at 701. Thus, the regulations rejected by *Beacon* and later codified by § 446(e) required consent regardless of whether a taxpayer proposed changing to a method that more accurately reflected its income.[7] In light of the changes enacted in the Internal Revenue Code of 1954, *Beacon* helps clarify that the Commissioner's consent is required for all changes in accounting methods, including "corrections" intended to more accurately reflect a taxpayer's true income. In sum, the 1954 Act created a prior consent requirement for changes in accounting method, which has since been repeatedly upheld.

Other language in the House and Senate Reports accompanying the Internal Revenue Code of 1954 conveys the same meaning. Both reports state: "In computing taxable income, a taxpayer who changes his general method of accounting or who treats material items inconsistently must obtain the consent of the Secretary or his delegate unless an express provision of this chapter permits such a change at the election of the taxpayer without consent." H.R.Rep. No. 1337, 83d Cong., 2d Sess. at A158 (1954); S.Rep. No. 1622, 83d Cong, 2d Sess. at 300-01 (1954). Thus, the reports accompanying H.R. 8300 clarified that any change in "material items . . . must obtain the consent of the Secretary." *Id.* The report includes in this class any "change in the method of depreciating *any* property." *Id.* (emphasis added).

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[7] This court does not mean to suggest that § 446(e) was enacted specifically to overturn the *Beacon* decision. *Beacon* was decided on January 3, 1955, months after the enactment of H.R. 8300. This court cites *Beacon* to illustrate the Tenth Circuit's view of the law prior to enactment of H.R. 8300, which altered the requirements for changes in accounting methods.

Thus, the language of § 446(e), the regulations clarifying § 446(e), the case law interpreting § 446(e) in six circuits, the statutory history of § 446(e) and its predecessors in earlier versions of the Code, as well as the legislative history accompanying § 446(e)'s enactment, separately and cumulatively establish that a taxpayer may not change from an incorrect to a correct accounting method without the Commissioner's consent. Regardless of the correctness of the original or the proposed new method, the taxpayer may not, under the 1954 Code, make the change without the Commissioner's consent.

In attempting to fit within the narrow correction exception for mathematical or technical errors within an original method of accounting, Dieboid relies principally upon three cases—one a decision of this court's predecessor. In *Gimbel Brothers, Inc. v. United States*, 210 Ct.Cl. 17, 535 F.2d 14, *later proceeding*, 211 Ct.Cl. 383 (1976), the taxpayer elected under § 44(a) of the 1939 Code (and § 453(a) of the 1954 Code) to report income from its department store sales on the installment method. At the same time, Gimbel Brothers reported one subclass of these sales, revolving credit plan sales, under a different and erroneous accrual method.

Upon discovering the error, Gimbel Brothers maintained that its election of the installment method in 1952 covered all its installment sales income, including that from revolving credit plan sales. Because it had deviated from its elected method, Gimbel Brothers sought to correct the error in applying its elected method, *not* to change its election. In short, Gimbel Brothers misapplied its validly elected method with respect to revolving credit sales, and the Court of Claims required correction of the error.

In contrast, Diebold selected at the outset no accounting method other than inventory for service modules. Nor does the plaintiff seek to correct an error in applying the inventory accounting method. Instead, the plaintiff at-

tempts to change from an inventory method to a depreciation method. *Gimbel Brothers*, therefore, is inapposite.

The second case, *Thompson-King-Tate, Inc. v. United States*, 296 F.2d 290 (6th Cir. 1961), is inapposite for the same reason. In *Thompson-King-Tate*, the taxpayer erroneously applied its completed contract method of accounting by reporting income in its 1953 and 1954 returns that should have been properly reported in 1955. The Sixth Circuit held that plaintiff could correct the error in applying its properly adopted method without the Commissioner's consent. Again, the plaintiff in *Thompson-King-Tate* did not vary from its original method of accounting.

Diebold also relies on *Amling-De Vor Nurseries v. United States*, 139 F. Supp. 303, 304 (N.D. Cal. 1956), in an effort to fit within the very narrow correction exception to the consent rule. *Amling-De Vor*, however, did not apply the consent requirement at all. Instead, the IRS opposed the plaintiff's amended returns on the ground that original returns were correct and required no correction. Like *Beacon*, *Amling-De Vor* concerned tax years prior to 1954 that were governed by § 41 of the 1939 Code. Accordingly, the correctness of the original returns was appropriately the central focus of the case.[8] Under current law and regulations, this distinction is no longer material to the outcome of this case. Section 446(e) now requires consent to change accounting methods regardless of whether the original method election was correct. 26 C.F.R. § 1.446-1(e)(2)(i)(a). Because the correction doctrine under § 41 of the 1939 Code is very different from the current correction exception under Treasury regulations, the *Amling-De Vor* decision does not support

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[8] Admitting that plaintiff's computations "present[ed] a muddy and unclear picture" of which method was in fact employed, the court in *Amling-De Vor*, nevertheless granted judgment for plaintiff on its refund claims. 139 F.Supp. at 304.

the plaintiff's effort to fit within the narrow regulatory exception.

Finally, plaintiff in its supplementary brief, cites *dictum* from *First National Bank of Gainesville v. Commissioner*, 88 T.C. 1069 (1987), for the proposition that it was not required to file Form 3115 to request consent for "correction" of its "error." Plaintiff's reliance again is misplaced.

In *Gainesville*, the plaintiff bank was a transferee of Hall Paving, a mining business. In 1976, Hall began to include soil aggregate in inventory at an erroneously overvalued rate of $1 per ton. Although it validly changed in 1977 to the LIFO inventory method—which requires inventory to be valued at cost—the mining business nevertheless maintained the erroneous valuation for soil aggregate until 1978. In 1979, the business attempted to decrease the value assigned to the soil aggregate to $.10 per ton. Although this transaction appears to be the permissible correction of a valuation error under an unchanged accounting method [9], the Tax Court held that the write-down constituted a change of accounting method without the Commissioner's consent.

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[9] This court's predecessor has recognized that an error in valuation within an original and unchanged accounting method may be corrected without securing consent. *Korn Industries, Inc. v. United States*, 209 Ct.Cl. 559, 532 F.2d 1352 (1976). The IRS, however, does not acquiesce in the *Korn Industries* holding. Rev. Rul. 77-134, 1977-1 C.B. 132, holds instead that any attempt to revise an erroneous computation that has extended over a period of years constitutes a change in accounting methods (because the adjustment involves deduction or income timing). The Ruling also stands for the broader proposition that "if a taxpayer has consistently treated an item of income or expense in a particular manner, any change from that consistent treatment is a change of accounting method regardless of whether the consistent treatment was a proper method of accounting." Rev.Rul. 80-190, 1980-2 C.B. 161, 162. This court, however, follows the ruling in *Korn Industries*.

The court also suggested in passing, however, that Hall might have corrected the 1976 error, among other ways, by filing an amended return for 1976 and subsequent years. The court's suggestion in *dicta* was presumably based on the perception that Hall had made an error in applying its existing inventory accounting method, that is, a permissible valuation error. In any event, the United States Tax Court was clearly aware that correction of an erroneous method of valuing inventory is a change of accounting method. *See Primo Pants Co. v. Commissioner*, 78 T.C. 705 (1982); *Fruehauf Trailer Corp. v. Commissioner*, 42 T.C. 83 (1964), *aff'd* 356 F.2d 975 (6th Cir.), *cert. denied*, 385 U.S. 822, 87 S.Ct. 51, 17 L.Ed.2d 60 (1966). This is evident from the Tax Court's holding in *Gainesville:* "Though the write-down of soil aggregate in 1979 may have constituted the correction of an error, it also constituted a change of accounting method pursuant to section 472(e). Where the correction of an error results in a change in accounting method, *the requirements of section 446(e) are applicable.*" 88 T.C. at 557 (emphasis added).

Accordingly, *Gainesville* is properly cited for the proposition that the correction of an error that constitutes a change of accounting method requires the Commissioner's consent. The taxpayer in *Gainesville* did not seek, as the plaintiff does, to have its product treated retroactively as noninventory depreciable assets. *Gainesville* and the other cases plaintiff cites hold that taxpayers may, without consent, correct *mere errors* in applying original accounting methods. In other words, a taxpayer may make, without obtaining consent, corrections that do not amount to changes of accounting method. Thus, these cases do not apply to the plaintiff's proposed change which clearly affects deduction timing.

In sum, construing this correction argument to resolve all possible doubts in Diebold's favor, the defendant is nevertheless entitled to judgment as a matter of law. Al-

though only allegedly seeking to correct an error, the plaintiff must still obtain the Commissioner's consent if correction of that error results in a change of accounting method. Because its amended return changed the timing of when the plaintiff would deduct the cost of the service modules, Diebold is correcting its error by changing accounting methods. Therefore, the plaintiff cannot make the correction without consent under § 446(e).

III. *"Regularly" requirement*

The Tax Code requires a taxpayer to secure the Commissioner's consent to any change in accounting method "on the basis of which he *regularly* computes his income." 26 U.S.C. § 446(e). Diebold's second challenge to the defendant's summary judgment motion is that it did not regularly employ inventory accounting treatment. The plaintiff instead contends that the first year (1976) in which it sought to depreciate its spare parts as capital assets is currently before the court.

Diebold relies primarily on *Silver Queen Motel v. Commissioner*, 55 T.C. 1101 (1971), for the proposition that a taxpayer may correct an accounting error in its first year without consent. Accordingly, the plaintiff asserts that correcting its choice of method for the first year the method was employed establishes that it had not regularly used the method in the intervening four years. To the contrary, undisputed facts indicate that Diebold's 1980 amendments attempted to change an accounting method for spare parts which plaintiff had treated as inventory at least from 1976 through 1979—a period sufficient to constitute regular usage under § 446(e).[10]

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[10] A taxpayer engaging in a new line of business may adopt an accounting method for that activity by using it in the first return in which income from that activity is reported. 26 C.F.R. § 1.446-1(e)(1). In its original 1976 return, Diebold treated service modules as inventory. If Diebold's use of modules in 1976 was in fact a

The plaintiff's attempt to avoid its regular treatment of spare modules as inventory is unavailing. *Silver Queen,* contrary to the plaintiff's contention, does not represent the proposition that a taxpayer may change its accounting method unilaterally as long as the proposed change reaches all the way back to the first year of the original method. In *Silver Queen,* the IRS disallowed the taxpayer's use of an impermissible method of depreciation in the taxpayer's first year of existence. Then the Service sought to impose straight-line depreciation on the taxpayer. The Tax Court agreed with the taxpayer that it should be allowed to change to the permissible 150% declining balance method without consent because the taxpayer was only in its first year and had not "regularly" used the impermissible method (double declining balance).

Silver Queen is distinguishable from this case on several grounds. First, uncontroverted facts show that the plaintiff used inventory treatment regularly from at least 1976 until 1979. Unlike Diebold, the *Silver Queen* was in its first tax year and had not even filed a second tax return, let alone established a regular method of accounting. Second, unlike *Silver Queen,* the Service has not disallowed the plaintiff's regular method. Instead, the plaintiff desires to change unilaterally its regularly established,

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new business, the plaintiff adopted inventory treatment as its method of accounting when it filed its original 1976 return.

The plaintiff, having used a method in its first return covering the activity, was bound to follow that method consistently thereafter. The regulations state: "(d) *Taxpayer engaged in more than one business.* (1) . . . The method *first* used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are *first* reported, *must be consistently followed thereafter.*" 26 C.F.R. § 1.446-1(d)(1) (emphasis added).

Moreover, the plaintiff employed inventory accounting from 1976 until 1980. Accordingly, even drawing all reasonable inferences against the movant, the facts indicate that the plaintiff "regularly" used inventory treatment as its method of accounting for spare service modules.

and presumably acceptable, method of inventory accounting. The IRS ordered the *Silver Queen* to change methods and then attempted to deny consent to the Motel's alternative method. Diebold, on the other hand, is not compelled to make a change and has not sought consent for its preferred alternative. Third, Diebold did not employ an alternative method of depreciation in its original returns, as did the Silver Queen Motel, but instead employed solely inventory treatment. Choosing between depreciation methods at the outset of a taxable venture is different from changing methods four years later.

Most significantly, Diebold, unlike the Silver Queen Motel, is not in its first year of existence. Whereas the Silver Queen Motel was able to change methods in its first year before establishing a regular accounting pattern, Diebold had a long established and regular pattern which it desired to change retroactively. The facts of *Silver Queen* are significantly different from the facts now before this court.[11]

The plaintiff also misplaces its reliance on *Foley v. Commissioner*, 56 T.C. 765 (1971). In *Foley*, the taxpayer purchased eighteen used vehicles in 1964. In his original return, Foley depreciated sixteen of the vehicles under the impermissible double-declining balance method (as in *Silver Queen*). Foley used straight-line depreciation for the other two. Later in the same year, Foley sought, in an amended 1964 return filed before his 1965 return, to depreciate all eighteen vehicles using the 150% declining balance method. As in *Silver Queen*, the Commissioner

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[11] For the same reason, other cases applying reasoning similar to that of *Silver Queen* are not persuasive. Both *Mamula v. Commissioner*, 346 F.2d 1016 (9th Cir.1965), and *Maid-Rite Steak Co. v. United States*, 643 F.Supp. 1162 (M.D.Pa. 1986), turn on the IRS rejection of an improper method in the first return covering the activity. Here the plaintiff seeks to make the change many years after employing an inventory, rather than a depreciation, accounting method.

disallowed the changes for both the sixteen and the two vehicles. The IRS preferred to impose straight-line depreciation on all of the transactions. Accordingly, the IRS argued that the plaintiff could not change his permissible straight-line method of accounting for the two vehicles without securing consent. Although Foley had amended his return before filing a return for the next year, the Commissioner relied on the consent requirement.

The United States Tax Court invoked *Silver Queen* for the proposition that the plaintiff may change an impermissible accounting method—the scheme used for the sixteen vehicles—without the Commissioner's consent.[12] Because the taxpayer had elected a permissible method for the two vehicles, the court disallowed any change without the Commissioner's consent. The consent rule was thus strictly enforced even though Foley had filed an amended return in the first year prior to any returns for future years.[13]

Foley is of no assistance, however, to the plaintiff in this instance. *Foley* involved an instance in which the amended return for the first year of the activity was filed *before* the filing of original returns for subsequent years. The plaintiff did not file its amended 1976 return until after it had filed initial returns for 1977, 1978, and 1979. In similar circumstances where the taxpayer has clearly

[12] As discussed earlier, the prevailing rule among courts of appeal would require a taxpayer to obtain permission for any change of accounting method, regardless of whether the initial method was permissible or impermissible. *See Witte*, 513 F.2d at 391.

[13] It is well established that, once a taxpayer selects a method of accounting in the first year of a taxable activity, the Commissioner's consent is required for any change in an amended return filed after the time for filing the initial return has expired. As stated in *Pacific Nat'l Co. v. Welch*, 304 U.S. 191, 194, 58 S.Ct. 857, 858, 82 L.Ed. 1282 (1938), "There is nothing to suggest that Congress intended to permit a taxpayer, after expiraiton of the time within which return is to be made, to have his tax liability computed and settled according to the other method."

adopted a regular method of accounting, the Tax Court, which is otherwise more lenient on the consent rule, requires the Commissioner's permission for a change. *Mitchell v. Commissioner*, 42 T.C. 953, 967-68 (1964); *Casey v. Commissioner*, 38 T.C. 357, 385-86 (1962).

Under the terms of a Revenue Ruling and a General Counsel Memorandum (G.C.M.), the IRS has acquiesced in the *Silver Queen* and *Foley* results where facts crucial to those two decisions are present. Rev. Rul. 72-491, 1972-2 C.B. 104, G.C.M. 38,680 (Apr. 18, 1981). These exceptions to the consent requirement are operative only where the taxpayer uses an erroneous method (of "depreciation" in the Ruling, of "accounting" in the G.C.M.) in the first year of the applicable activity. In these limited cases, the taxpayer may, without seeking consent, change to a correct method of depreciation or accounting for the first year if either: (a) The IRS disallows the use of the erroneous method in that first year (as in *Silver Queen*), or (b) the taxpayer files an amended return, using a correct method, for the first year before filing his return for the following year (as in *Foley*).

The plaintiff does not meet either criterion. The Revenue Ruling allows a taxpayer, in certain specified circumstances, to correct "an erroneous method of depreciation" without consent. The plaintiff, however, clearly seeks to "correct" its treatment of items classified as inventory. Inventory treatment is not a method of depreciation; thus, Diebold had no method of depreciation to correct. Moreover, the plaintiff is not attempting to correct a method rejected by the IRS in the first year before filing a subsequent year's return. The ruling does not apply to the plaintiff.

The G.C.M. applies to liquidations under § 334(b)(2) where the taxpayer, "prior to filing its return for the following tax year," attempts by amended return to correct "the liquidated subsidiary's impermissible method of

accounting for items in its inventory." G.C.M. 38,680. In this case, however, the plaintiff filed returns for 1977, 1978, and 1979 before attempting to amend its 1976 return. Thus, the plaintiff does not meet the requirements of G.C.M. 38,680.

The plaintiff states that it initiated the 1980 amendment to the 1976 and 1977 returns to be consistent with positions taken by the revenue agent in charge of the audits for 1974 and 1975. By this argument, the plaintiff attempts to establish that the 1974 and 1975 audits implicitly disallowed the 1976 inventory method. The audit of the plaintiff's 1974 and 1975 returns focused on conversion modules, not its 1976 treatment of spare service modules. By definition, the revenue agent's comments regarding tax years 1974 and 1975 could not have constituted a disallowance of the plaintiff's 1976 treatment of spare parts, especially if, as Diebold maintains, 1976 was the first year in which it held a pool of rotatable replacement modules.

The plaintiff's argument that the Revenue Ruling is an improper limitation of *Silver Queen* and *Foley*, overlooks the express language of the Tax Code. The statute requires the Commissioner's consent for any change of accounting method unless specifically excepted by the Tax Code. The Commissioner has essentially granted consent in advance in cases presenting the same circumstances as *Silver Queen* or *Foley*. This is not such a case.

Although *Silver Queen* and *Foley* are factually distinguishable from this case, these decisions also represent a legal policy unique to the United States Tax Court. Unlike several circuit courts, the Tax Court has granted taxpayers leeway to correct impermissible or incorrect accounting methods without securing the Commissioner's consent. This divergence of Tax Court policy was noted in *Southern Pacific Transportation Co. v. Commissioner:*

> On the question of whether consent is necessary to change from a clearly incorrect accounting method,

> some Courts of Appeals have adopted a fairly strict approach. See, for example, *Witte v. Commissioner*. In each of the appellate decisions cited above, the Court of Appeals held that the consent of the Commissioner is necessary for a change even where the taxpayer's old method is shown to be wrong. This Court has tended not to require consent in such situations.

75 T.C. 497, at 682 n. 208 (citations omitted).

This unique Tax Court policy, however, is not consistent with the language and history of § 446(e)[14] that the language and history is accurately reflected by regulations which specifically require that consent to change an accounting method "must be secured whether or not such method is proper." 26 C.F.R. § 1.446-1(e)(2)(i). This clarification of the stated intent of Congress has, as noted earlier, been upheld by numerous appellate court decisions. *See, e.g.*, *Witte*, 513 F.2d at 394; *Poorbaugh*, 423 F.2d at 163; *Wright Contracting*, 316 F.2d at 249.

Of singular importance, this unique policy of the United States Tax Court does not accurately reflect the law in this circuit. *Hackensack Water*, 352 F.2d at 807; *Ed Smithback Publishing*, 209 Ct.Cl. at 743, 538 F.2d 347. According to the prevailing view, the statute and regulations require the Commissioner's consent even when the change is from an improper method.

IV. *Purpose of consent requirement*

The plaintiff posits, as a third reason to avoid § 446(e), that the underlying purposes of the consent requirement will be frustrated by prohibiting a change that does not require compensating adjustments. The plaintiff seeks again, in essence, to avoid the consent rule because changing from an incorrect to a correct method would accurately reflect its income and require no further adjust-

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[14] *See supra* notes 4-5 and accompanying text.

ments. Although the court, for purposes of this motion, accepts plaintiff's assertion that no adjustments would be necessary, the Internal Revenue Code simply does not condition the consent rule upon a showing that adjustments will be necessary. The Commissioner is charged with the responsibility of ascertaining what adjustments are required when a taxpayer applies for consent to switch methods. Unlike the 1939 Tax Code, however, the need for adjustments is not, under current law, the test for whether the taxpayer must request consent at all. Consent is required except "as otherwise provided" in the statute or regulation. 26 U.S.C. § 446(e).

The policy underlying the consent rule was articulated by the Supreme Court in *Pacific National Co. v. Welch*, 304 U.S. 191, 194, 58 S.Ct. 857, 858, 82 L.Ed. 1282 (1938):

> Change from one method to the other, as petitioner seeks, would require recomputation and readjustment of tax liability for subsequent years and impose burdensome uncertainties upon the administration of the revenue laws. It would operate to enlarge the statutory period for filing returns (§ 53(a)) to include the period allowed for recovering overpayments (§ 322(b)). There is nothing to suggest that Congress intended to permit a taxpayer, after expiration of the time within which return is to be made, to have his tax liability computed and settled according to the other method.[15]

The Court of Claims employed similar reasoning in stating the reasons for § 446(e): "The courts have enforced the Commissioner's permission requirement to enable him

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[15] Since amendment of the consent requirement in 1954, this passage from *Pacific National*, 304 U.S. at 194, 58 S.Ct. at 858, has been endorsed as an appropriate statement of the reasons for the consent requirement. *Lord v. United States*, 296 F.2d 333, 335 (9th Cir.1961).

to protect the fisc most effectively. Any change of accounting method will almost certainly distort net income in the year of change." *Wanamaker Philadelphia, Inc. v. United States*, 175 Ct.Cl. 169, 175, 359 F.2d 437, 440 (1966).

Finally the United States Tax Court has identified several policies served by this section of the Internal Revenue Code: "(1) to protect against the loss of revenue; (2) to prevent administrative burdens and inconvenience in administering the tax law; and (3) to promote consistent accounting practice thereby securing uniformity in the collection of revenue." *Barber v. Commissioner*, 64 T.C. 314, 319-20 (1975) (citations omitted).

According to these decisions, a central policy underlying the consent requirement is that the Commissioner should have an opportunity to review consent requests in advance. With advance notice, the Commissioner has leverage to protect the fisc, to avoid burdensome administrative uncertainties, and to promote accounting uniformity. If taxpayers generally were permitted to change accounting methods unilaterally, the Commissioner would face the enormous administrative burden of detecting changes and reviewing the propriety of each switch without ready leverage to protect the fisc or promote uniformity.

In the absence of the prior consent rule, a taxpayer could adopt a method of accounting and after several years unilaterally switch to an alternative method which hindsight suggests would have been more financially beneficial. Thus, the Commissioner's ability to protect the fisc and prevent unnecessary variations in accounting procedures would be substantially reduced. In order to avoid missing taxable income, the IRS would be required to multiply its detection and examination efforts to prevent abuse of unconsented retroactive changes. The administrative advantages of advance notice are thus

integrally linked to the purposes of protecting the fisc and promoting accounting uniformity.

The plaintiff retorts that its switch to a correct accounting procedure will not endanger the fisc or disrupt uniformity. The D.C. Circuit considered and rejected this argument: "The danger of distortion of income detrimental to governmental revenue exists regardless of whether the change in method is from one proper method to another or from an improper method to a proper one." *Witte*, 513 F.2d at 394.

Moreover, the plaintiff in this case desires to make precisely the kind of change that could undermine the purposes of the prior consent rule. The plaintiff seeks to apply a unilateral change retroactively to cover many past tax years. If taxpayers were permitted to select the accounting method which best reflects their income over the past four years, only those taxpayers gaining a financial advantage from switching methods would seek refunds. Thus, uniformity in accounting would become a function of financial advantage and the administrative difficulties of detecting unwarranted unilateral changes would be multiplied. Moreover, the potential impact on the fisc would be likely to vary unpredictably from year to year. In sum, the purposes and policies underlying the consent requirement are still served when a taxpayer presumes to change unilaterally from an incorrect to a correct procedure.

V. *Was consent granted?*

The plaintiff argues that even if the proposed change of accounting methods requires consent, the Commissioner has already granted consent. The plaintiff finds this implied consent in the Revenue Agent's Report (RAR) issued after audit of the plaintiff's 1974 and 1975 tax years, in the RAR for 1976 and 1977, and in the payment of a refund on 1979 taxes. For various reasons, none of these events constituted consent, express or implied, sufficient to satisfy § 446(e).

A. 1974 and 1975 Audit

The plaintiff claims to have already secured consent because the accounting change for spare service modules was initiated by the IRS' examination of plaintiff's "retrofitting" or ATM conversions in years 1974 and 1975. In the 1974 and 1975 audits, the Service and the plaintiff negotiated an agreement under which Diebold would: (a) deduct one-half of the costs of converting "A" and "B" units into "C" units in 1975 and one-half in 1976; and (b) treat R & D costs in developing the "C" model as having created an amortizable intangible asset, as the Service proposed.

The plaintiff contends that this action led its tax manager to believe that the Service had approved treatment of all replacement modules—both rotatable service modules and conversion modules—as noninventory capital assets. Thus, the plaintiff sought by amended returns for 1976 and 1977 to depreciate the service modules to comply with IRS guidance. The plaintiff states that its tax manager's belief that this was the proper treatment was "reconfirmed" by its receipt in February 1981 of a refund check for taxable year 1979. For this reason, "no Form 3115 was filed." Pl.Br. filed May 29, 1987, at 11. The solitary belief of the plaintiff's tax manager is simply not supported by adequate corroborating evidence. Other than the coincidence that both the 1974-75 audit and the 1976 proposed change deal with ATM modules, these two events have very little in common. At issue in the 1974 and 1975 audits was treatment of the costs of converting "B" models to "C" models and R & D expenses. The settlement had nothing whatsoever to do with the plaintiff's accounting treatment for spare service modules. The plaintiff does not present any facts that would give its tax manager a basis for believing the IRS had approved any treatment at all of service modules. Neither the Service's partial allowance of Diebold's 1975 deduction of conversion costs nor the IRS-imposed amorti-

zation of R & D expenses could logically have approved any change in spare service module treatment.

Furthermore, the plaintiff maintains that it did not even engage in the activity of using rotatable service modules until 1976. If this is correct, the revenue agent could hardly have proposed to change, in 1974 and 1975, Diebold's accounting treatment of a non-existent activity.[16] The 1974 and 1975 audit changes, in sum, could not have imposed on plaintiff a method of depreciation for the service modules. The record shows that the audit changes allowed no 1976 depreciation at all.

B. The 1976 and 1977 Audit

The plaintiff observes that the revenue agent for the 1976-77 audit agreed partially, in proposing audit changes, with its current position that spare modules are noninventory depreciable assets. The plaintiff argues essentially that the revenue agent's position, as set forth in the 1976-77 RAR, constitutes consent to Diebold's proposed 1980 change. The defendant answers that the Commissioner ultimately denied the plaintiff's claims for 1976 and 1977 refunds.

According to uncontroverted facts, the Commissioner obviously did not concur in the revenue agent's proposed treatment of Diebold's service modules. In other words, the Commissioner did not "accept" amended returns going back to the "first year" in which plaintiff offered service contracts that included replacement parts at no additional

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[16] Defendant notes and the court agrees, that the parties' different interpretations of the effect of the RAR does not create a genuine issue of material fact. The contents of the RAR are in the record and not disputed. The court is free, consequently, to find that the revenue agent's proposals (concerning as they did, conversion and R & D expenses) had nothing to do with Diebold's spare modules (whenever it put them into service). While there is an issue as to *when* Diebold began the activity in question, it is strictly immaterial to whether Diebold obtained consent to change its accounting method.

charge. As a matter of law, a revenue agent's initial position, taken prior to final action on a refund claim, does not bind the Commissioner. *See Biewer v. Commissioner*, 341 F.2d 394, 396-97 (6th Cir.1965); *H.F. Campbell Co. v. Commissioner*, 53 T.C. 439, 449-50 (1969), *supplemented*, 54 T.C. 1021 (1970), *aff'd*, 443 F.2d 965 (6th Cir.1971) (revenue agent's recommendations to be viewed as tentative; it was Commissioner's prerogative to reject them). Moreover, § 446(e) requires the Commissioner's final, as opposed to an agent's preliminary, consent to a change of accounting method. The Commissioner's 1976-77 audit denied consent to the proposed change of accounting method.

Finally, the RAR for the plaintiff's 1976 and 1977 taxable years is dated August 20, 1981. The plaintiff attempted to change accounting methods in amended returns dated October 6, 1980. The Tax Code requires a taxpayer to obtain the Commissioner's consent prior to changing methods. A revenue agent's remarks subsequent to the change does not constitute a prior approval by the Commissioner, as required by law.

C. The 1979 Refund

In October 1980, plaintiff amended its 1976, 1977, 1978, and 1979 returns to claim depreciation on service modules. In late December 1980 and in February 1981, plaintiff received the refund claimed for 1979. The plaintiff argues that issuance of the refund constituted consent to its use of the (new) accounting method. This consent argument ultimately fails also.

The defendant relies on the September 14, 1987 Declaration of Antoinette M. Cross of the IRS' Cincinnati Tax Accounts Division in stating that payment of the 1979 claim was contrary to IRS procedures and therefore unauthorized. The statements made by Ms. Cross are supported by the documentary evidence. The plain-

tiff fails, by affidavit or otherwise,[17] in any way to take issue with the facts as the defendant presents them.[18]

Regardless of the validity of the procedures recounted by Ms. Cross, however, the refund of the 1979 taxes was issued on December 23, 1980. The notification of the allowance of the refund was sent by the IRS to the plaintiff on February 2, 1981. The plaintiff had filed its amended 1976 and 1977 returns (Form 1102X) on October 6, 1980. The Service's questioned allowance of the 1979 refund occurred *after* the plaintiff sought to change accounting methods. Section 446(e) of the Internal Revenue Code clearly requires a taxpayer to secure the Commissioner's consent "before computing his taxable income under the new method." 26 U.S.C. § 446(e). Accordingly, the allowance of a refund for 1979 subsequent to the filing of the amended returns, even if construed to constitute a valid consent, would not satisfy the terms of the Code.

For other reasons as well, the 1979 refund did not constitute consent to plaintiff's change in accounting for taxable years 1976 and 1977. The plaintiff's 1979 refund claim did not disclose on its face that it was based on a change of accounting method, but purported merely to correct an error. The 1979 refund was issued prior to examination of the plaintiff's 1979 taxable year and two years before its 1976 and 1977 amended returns were processed. As a result, the agent who processed the 1979 claim was not likely to have known it was based on a

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[17] The court provided the parties an opportunity to argue the merits of this motion during a status conference on November 17, 1988.

[18] The essence of the defendant's contention is that because the 1979 refund payment was made in violation of IRS regulations and 26 U.S.C. § 6405, it was unauthorized. The United States is not bound by its agent's unauthorized acts. *Federal Crop Ins. Corp. v. Merrill,* 332 U.S. 380, 68 S.Ct. 1, 92 L.Ed. 10 (1947); *Bornstein v. United States,* 170 Ct.Cl. 576, 582, 345 F.2d 558, 562 (1965).

change of accounting method. The plaintiff failed to put the agent, and certainly the Commissioner, on notice of the change of method. *See, e.g., Fowler Bros. & Cox v. Commissioner,* 138 F.2d 774, 775-76 (6th Cir.1943) (Commissioner may grant consent informally by accepting amended return that puts him on notice that taxpayer has changed its accounting method); *Falk v. Commissioner,* 37 T.C. 1078, 1085 (1962), *aff'd,* 332 F.2d 922 (5th Cir.1964).

After citing *Fowler Bros.* and other implied consent cases, the Court of Claims suggested in *Ed Smithback Publishing,* that "in those cases [where] the Commissioner was fully aware of the change in accounting methods . . . or played some part in initiating said change . . .," consent may be implied. 37 A.F.T.R.2d ¶ 76-366, at 496, *adopted,* 209 Ct.Cl. at 743. In contrast, the Commissioner clearly did not initiate the 1979 change and the plaintiff failed to disclose its unilateral accounting method change. The facts indicate that the Commissioner after audit of the 1976 and 1977 years, disallowed the change for 1976 and 1977 and currently proposes to do so for 1978 and 1979.[19] In the absence of adequate notice of the change, the Commissioner cannot be deemed to have "accepted" the amended returns or given consent to a change of method.

VI. *Distortion of income*

The plaintiff seeks to avoid the consent requirement by arguing that retention of its original accounting treatment results in a distortion of its income for the years in

[19] Even if the 1979 refund could be construed as consent to a change of method, the court deems that such consent would not operate retroactively to 1976. The regulation suggests that changes of method (and consent) are effective only prospectively. 26 C.F.R. § 1.446-1(e)(3)(i) requires filing of Form 3115 "*within 180 days* after the *beginning of the taxable year* in which it is *desired* to make the change" (emphasis added). Accordingly, such "consent" would be effective, if at all, only from 1979.

question. To avoid "a mismatching of income and deductions," plaintiff argues, a change of accounting method for rotatable service modules should be permitted by this court. Pl.Br. filed May 29, 1987, at 18-19.

For purposes of this motion, the court assumes that treating Diebold's modules as inventory mismatches income and deductions, nonetheless this contention is not sufficient to deny the defendant judgment as a matter of law. Regardless of whether the plaintiff's inventory accounting method distorted income, the plaintiff, by virtue of having used that method regularly in reporting income, at least from 1976 through 1979, was obligated to secure consent prior to making a method change. 26 C.F.R. § 1.446-1(e)(2)(i). If the plaintiff had filed Form 3115 requesting a change in accounting methods, and the Commissioner had then disallowed the change, the plaintiff's distortion of income argument would appropriately raise the question of whether the Commissioner abused his discretion. *See generally Clement v. United States*, 217 Ct.Cl. 495, 580 F.2d 422 (1978), *cert. denied*, 440 U.S. 907, 99 S.Ct. 1214, 59 L.Ed.2d 455 (1979).

The Commissioner has broad discretion to permit or deny a requested change. *Brown v. Helvering*, 291 U.S. 193, 204, 54 S.Ct. 356, 361, 78 L.Ed. 725 (1934); *Southern Pac. Transp.*, 75 T.C. at 681. The failure of the Commissioner to grant permission can successfully be challenged only by a showing that the Commissioner's decision was arbitrary or an abuse of discretion. *Schram v. United States*, 118 F.2d 541, 544 (6th Cir.), *cert. denied*, 314 U.S. 695, 62 S.Ct. 412, 86 L.Ed. 555 (1941); *Casey v. Commissioner*, 38 T.C. 357, 386 (1982) (Acq.); *Advertisers Exchange, Inc. v. Commissioner*, 25 T.C. 1086, 1093 (1956), *aff'd per curiam*, 240 F.2d 958 (2d Cir. 1957). As stated in *Southern Pacific*, "[I]t is not sufficient for a taxpayer merely to show the correctness of the new method; that fact alone cannot justify a change without

the Commissioner's consent." 75 T.C. at 681; *see Wright Contracting Co. v. Commissioner*, 316 F.2d 249 (5th Cir. 1963), *aff'g* 36 T.C. 620 (1961).[20]

Until the plaintiff seeks consent, the Commissioner has exercised no discretion which this court can examine for abuse. The argument that the Commissioner's failure to consent sanctions a distortion of income cannot relieve plaintiff of its statutory obligation to seek the required consent. Until the plaintiff gives the Commissioner an opportunity to consent in the manner provided by law and regulation, i.e., in response to filing of a Form 3115, the issue of whether its original accounting method distorts income is immaterial.

VII. *Equal treatment*

The plaintiff contends as well that the Commissioner's position in this case puts it at a competitive disadvantage. The plaintiff states that the Commissioner has permitted other companies such as Memorex Corporation to treat their rotatable spares as depreciable assets. Consequently, the plaintiff argues that it is entitled to prevail in this case under principles of *International Business Machines*

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[20] Where the proposed new method would be more correct than the old, the Commissioner's consent is nonetheless essential. *H.F. Campbell Co. v. Commissioner*, 53 T.C. 439, 448 (1969), *aff'd*, 443 F.2d 965 (6th Cir.1971). While the Tax Court has sometimes not required consent where taxpayer attempts to change from a clearly incorrect accounting method, various courts of appeals have adopted a strict approach, as has the Tax Court on occasion. *See generally supra* p. 206.

The Court of Claims, as stated previously, has required consent even where the taxpayer seeks to change an incorrect method. *See Ed Smithback Publishing*, 37 A.F.T.R.2d at 76-495 (citing *Witte*, for the proposition that consent is required even if "the change was to correct use of a previous but erroneous method"). This court is bound by Court of Claims precedent. It also believes that the view of the consent requirement adopted in this circuit and at least six others is more in harmony with the language of the Tax Code and the intent of Congress.

Corp. v. United States, 170 Ct.Cl. 357, 343 F.2d 914 (1965), *cert. denied,* 382 U.S. 1028, 86 S.Ct. 647, 15 L.Ed.2d 540 (1966).

In *IBM,* the computer company sued to recover excise taxes paid on business machines from 1951 through 1958, alleging that the Commissioner had treated its competitor Remington Rand more favorably. Both companies in the years 1951-58 were engaged in the manufacture, sale, and lease of competing computer systems. Prior to 1955, both had paid excise tax on these articles pursuant to I.R.C. § 3406(a)(6) (1939), and its replacement I.R.C. § 4191 (1954). Remington Rand in April 1955 requested and received a ruling that certain of its machines were not subject to the tax.[21] Three months later IBM made a ruling request identical in relevant part to that of Remington Rand; it was denied. The court held that the Commissioner had abused his discretion when he denied IBM's request but made Remington Rand's machines taxable only prospectively from February 1, 1958, while IBM's machines were taxable at all times.

In this case, however, the plaintiff did not request, in the manner prescribed by 26 C.F.R. § 1.446-1(e)(2)(i), consent to switch methods. Not having a chance to exercise discretion, the Commissioner could not, as in *IBM,* have abused it. The plaintiff concedes that it did not file Form 3115 to request consent to a change of accounting method. Hence, the plaintiff has no basis to assert that such a request was granted to a different taxpayer. *Bornstein,* 170 Ct.Cl. at 585-86, 345 F.2d 558, cites *IBM* for the proposition that since plaintiffs did not request a ruling, and chose instead to rely on a private ruling issued to another corporation, the Commissioner was free to

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[21] That ruling was revoked in 1957, but only prospectively, about the time IBM's request was denied. Remington Rand machines, accordingly, were exempt from the excise tax from 1955 to 1957. *See* 170 Ct.Cl. a 358-60, 345 F.2d 558.

treat plaintiffs differently from taxpayers who had secured rulings, without abusing his discretion.

In addition, *IBM* has been strictly limited to its particular circumstances. *See, e.g., Carpenter v. United States*, 7 Cl.Ct. 732, 739 (1985), *aff'd mem.*, 790 F.2d 91 (Fed. Cir. 1986); *Knetsch v. United States*, 172 Ct.Cl. 378, 391 n.14, 348 F.2d 932, 940 n.14 (1965), *cert. denied*, 383 U.S. 957, 86 S.Ct. 1221, 16 L.Ed.2d 300 (1966). In a refund suit, plaintiff has the burden of proving its entitlement to the relief it seeks. *Carpenter*, 7 Cl.Ct. at 739. The mere fact that another taxpayer has been treated differently from the plaintiff does not establish the plaintiff's entitlement.[22] On the facts, defendant is entitled, as a matter of law, to prevail because plaintiff, not having requested consent to change its accounting method, cannot establish that the Commissioner exercised any discretion to be reviewed by this court.

VIII. *Alleged disputes of material fact*

Finally, plaintiff attempts to suggest that material fact disputes persist. However, the facts genuinely in dispute are not material to the disposition of a motion based "solely on plaintiff's attempt to change its method of accounting for certain rotatable spare service parts without having properly requested or obtained the consent of the Commissioner." Def.'s Brief filed March 17, 1987, at 1.

The substantive legal question presented in this case is whether taxpayer is entitled by an amended return to change treatment of rotatable spare service parts from

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[22] *Carpenter*, 7 Cl.Ct. at 740-41 (distinguishing *IBM* on the basis that both taxpayers had made ruling requests whereas in *Carpenter* they had not); *Easter House v. United States*, 12 Cl.Ct. 476, 489-90 (1987) ("[T]axpayer cannot premise its right to an exemption by showing that others have been treated more generously, leniently or erroneously by IRS. The fact that there may be some taxpayers who have avoided paying a tax does not relieve others similarly situated from paying their taxes.")

inventory to depreciable assets qualifying for an investment tax credit without first obtaining the consent of the Commissioner of Internal Revenue to a change in method of accounting as required by § 446(e).

Because the substantive law of this case involves consent requirements for changes in accounting methods, facts concerning a taxpaying corporation's original methods of accounting, its attempt (if any) to change that treatment, its efforts to procure consent for actual changes, and its eligibility for any exceptions to the consent rule are all material. Thus, several potential disputed issues of fact are not material. For instance, the plaintiff contends, and the IRS disputes, that the spare service modules may only be correctly classified as depreciable property. This dispute is immaterial because the substantive law requires consent regardless of the correctness of the initial accounting method. In addition, the facts establish that the IRS never disallowed the original inventory treatment, thus suggesting that the initial methodology was at least acceptable at the time that the plaintiff made its unilateral switch of methods.

The plaintiff also asserts the existence of a contested issue of material fact as to whether 1974 or 1976 was the first year of inventory treatment. This question, however, can be answered by resort to the plaintiff's own Proposed Findings: "[A]t the introduction of the Tabs 500 to the market in *1974, for* both financial reporting and *tax purposes, plaintiff* erroneously *accounted for its spare service modules* by treating them . . . *as* a non-depreciable asset (*inventory*) without a determinable life, rather than to expense or depreciate the modules." Pl. Findings ¶ 30 (emphasis added).

While this court could find that plaintiff's proposed finding amounts to a stipulation that Diebold began to treat spare modules as inventory as early as 1974, this question still does not create an issue of material fact. Even if this factual dispute is genuine, it is immaterial

for purposes of the current motion. The defendant is entitled to prevail as a matter of law even if, as plaintiff contends, 1976 was the first year in which Diebold conducted the activity.

Because the plaintiff had regularly employed inventory accounting from 1976-1979,[23] the Commissioner's consent was required prior to any change in methods. The plaintiff endeavors to establish that 1976, the alleged first year of the taxable activity, is currently before the court. Therefore, the plaintiff maintains, the court should treat its 1976 return as a "first return" that might be changed without consent. Had plaintiff sought to change its adoption of inventory accounting in an amended 1976 return filed on or before the deadline for filing the original 1976 return, such return would have been considered a "first" return. *Haggar Co. v. Helvering*, 308 U.S. 389, 395, 60 S.Ct. 337, 340, 84 L.Ed. 340 (1940); *Philadelphia Brewing Co. v. United States*, 89 Ct.Cl. 297, 27 F.Supp. 583 (1939). In general, however, once a taxpayer adopts an accounting method, and the deadline for filing the original return passes, the Commissioner is not obligated to accept a change of method in an amended return. *See, e.g., Pacific Nat'l*, 304 U.S. at 191, 58 S.Ct. at 857.

Nor is G.C.M. 38,680 of any assistance to the plaintiff. Even assuming that the plaintiff is correct that 1976 was the first year of the activity, the defendant is entitled to prevail as a matter of law because the plaintiff did not file an amended return for 1976 before the time for filing its 1977 return had expired. The parties have stipulated that plaintiff filed its amended 1976 return in 1980. Hence plaintiff cannot take advantage of the "first return" exception contained in G.C.M. 38,680.

The plaintiff's attempt to establish material factual disputes fails. The first year of the taxable activity is not material because the plaintiff clearly employed inventory

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[23] *See supra*, note 7 and accompanying text.

treatment as a regular accounting method for several years before attempting to switch. Also, the correct tax treatment of the rotatable service modules is not material because the correctness of the new (original) method is no longer relevant under the prior consent rule of § 446(e).

CONCLUSION

In the absence of a genuine issue of material fact, defendant is entitled to judgment as a matter of law. Accordingly, the court grants defendant's motion and directs the clerk to enter judgment for the United States and to dismiss the plaintiff's complaint.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

89-1349

DIEBOLD, INCORPORATED,
Plaintiff-Appellant,
v.

THE UNITED STATES,
Defendant-Appellee.

ORDER

Before FRIEDMAN, Circuit Judge, BALDWIN, Senior Circuit Judge, and MAYER, Circuit Judge.

A petition for rehearing having been filed in this case, and a response thereto having been invited by the court and filed,

UPON CONSIDERATION THEREOF, it is

ORDERED that the petition for rehearing be, and the same hereby is, denied.

The suggestion for rehearing in banc is under consideration.

The mandate will issue on April 2, 1990.

FOR THE COURT

/s/ Francis X. Gindhart
FRANCIS X. GINDHART
Clerk

Dated: March 26, 1990

cc: LYMAN G. FRIEDMAN
CHARLES BRICKEN

APPENDIX D

THE TREASURY REGULATION INTERPRETING SECTION 446(e)

Treas. Reg. § 1.446-1 (1988). General rule for methods of accounting.

(a) *General rule.* (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements methods, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conversation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

* * * *

(e) *Requirement respecting the adoption or change of accounting method.* (1) A taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. See section 446(c) and paragraph (c) of this section for permissible methods. Moreover, a taxpayer may adopt

any permissible method of accounting in connection with each separate and distinct trade or business, the income from which is reported for the first time. See section 446(d) and paragraph (d) of this section. See also section 446(a) and paragraph (a) of this section.

(2) (i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder.

(ii) (*a*) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder), a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.451-3), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method, and a change where

the Internal Revenue Code and regulations thereunder specifically require that the consent of the Commissioner must be obtained before adopting such a change.

(*b*) A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction which does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, corrections of items that are deducted as interest or salary, but which are in fact payments of dividends, and of items that are deducted as business expenses, but which are in fact personal expenses, are not changes in method of accounting. In addition, a change in the method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts or an adjustment in the useful life of a depreciable asset. Although such adjustments may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustments in the current and future years. For the treatment of the adjustment of the addition to a bad debt reserve, see the regulations under section 166 of the Code; for the treatment of a change in the useful life of a depreciable asset, see the regulations under section 167(b) of the Code. A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts. On the other hand, for example, a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which has been consistently treated as an expense in the year of purchase involves the question of the proper

timing of an item, and is to be treated as a change in method of accounting.

(*c*) A change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Also a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method of accounting.

(iii) A change in the method of accounting may be illustrated by the following examples:

Example (1). Although the sale of merchandise is an income producing factor, and therefore inventories are required, a taxpayer in the retail jewelry business reports his income on the cash receipts and disbursements methods of accounting. A change from the cash receipts and disbursements method of accounting to the accrual method of accounting is a change in the overall plan of accounting and thus is a change in method of accounting.

Example (2). A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis except for real estate taxes which have been reported on the cash receipts and disbursements method of accounting. A change in the treatment of real estate taxes from the cash receipts and disbursements method to the accrual method is a change in method of accounting because such change is a change in the treatment of a material item within his overall accounting practice.

Example (3). A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis. Vacation pay

has been deducted in the year in which paid because the taxpayer did not have a completely vested vacation pay plan, and, therefore, the liability for payment did not accrue until that year. Subsequently, the taxpayer adopts a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to the year in which the liability to make the payment now arises. The change for the year of deduction of the vacation pay plan is not a change in method of accounting but results, instead, because the underlying facts (that is, the type of vacation pay plan) have changed.

Example (4). From 1968 through 1970, a taxpayer has fairly allocated indirect overhead costs to the value of inventories on a fixed percentage of direct costs. If the ratio of indirect overhead costs to direct costs increases in 1971, a change in the underlying facts has occurred. Accordingly, an increase in the percentage in 1971 to fairly reflect the increase in the relative level of indirect overhead costs is not a change in method of accounting but is a change in treatment resulting from a change in the underlying facts.

Example (5). A taxpayer values inventories at cost. A change in the basis for valuation of inventories from cost to the lower of cost or market is a change in an overall practice of valuing items in inventory. The change, therefore, is a change of method of accounting for inventories.

Example (6). A taxpayer in the manufacturing business has for many taxable years valued its inventories at cost. However, cost has been improperly computed since no overhead costs have been included in valuing the inventories at cost. The failure to allocate an appropriate portion of overhead to the value of inventories is contrary to the requirement

of the Internal Revenue Code and the regulations thereunder. A change requiring appropriate allocation of overhead is a change in method of accounting because it involves a change in the treatment of a material item used in the overall practice of identifying or valuing items in inventory.

Example (7). A taxpayer has for many taxable years valued certain inventories by a method which provides for deducting 20 percent of the cost of the inventory items in determining the final inventory valuation. The 20 percent adjustment is taken as a "reserve for price changes." Although this method is not a proper method of valuing inventories under the Internal Revenue Code or the regulations thereunder, it involves the treatment of a material item used in the overall practice of valuing inventory. A change in such practice or procedure is a change of method of accounting for inventories.

Example (8). A taxpayer has always used a base stock system of accounting for inventories. Under this system a constant price is applied to an assumed constant normal quantity of goods in stock. The base stock system is an overall plan of accounting for inventories which is not recognized as a proper method of accounting for inventories under the regulations. A change in this practice is, nevertheless, a change of method of accounting for inventories.

(3) (i) Except as otherwise provided under the authority of subdivision (ii) of this subparagraph, in order to secure the Commissioner's consent to a change of a taxpayer's method of accounting, the taxpayer must file an application on Form 3115 with the Commissioner of Internal Revenue, Washington, D.C. 20244, within 180 days after the beginning of the taxable year in which it is desired to make the change. The taxpayer shall, to the extent applicable, furnish (a) all information requested on such form,

disclosing in detail all classes of items which would be treated differently under the new method of accounting and showing all amounts which would be duplicated or omitted as a result of the proposed change and (b) the taxpayer's computation of the adjustments to take into account such duplications or omissions. The Commissioner may require such other information as may be necessary in order to determine whether the proposed change will be permitted. Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms, conditions, and adjustments under which the change will be effected. See section 481 and the regulations thereunder, relating to certain adjustments required by such changes, section 472 and the regulations thereunder, relating to changes to and from the last-in, first-out method of inventorying goods, and section 453 and the regulations thereunder, relating to certain adjustments required by a change from an accural method to the installment method.

(ii) Notwithstanding the provisions of subdivision (i) of this subparagraph, the Commissioner may prescribe administrative procedures, subject to such limitations, terms, and conditions as he deems necessary to obtain his consent, to permit taxpayers to change their accounting practices or methods to an acceptable treatment consistent with applicable regulations. Limitations, terms, and conditions, as may be prescribed in such administrative procedures by the Commissioner, shall include those necessary to prevent the omission or duplication of items includible in gross income or deductions.

(2)

No. 89-1999

In the Supreme Court of the United States

OCTOBER TERM, 1990

DIEBOLD, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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17 pp

QUESTION PRESENTED

Whether petitioner's changing the characterization of its modular spare parts for automated teller machines from inventory to assets subject to depreciation, in order to claim investment tax credits and depreciation deductions with respect to those parts, constitutes a change in method of accounting for which the prior consent of the Commissioner of Internal Revenue is required under Section 446(e) of the Internal Revenue Code.

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DIEBOLD, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-8a) is reported at 891 F.2d 1579. The opinion of the Claims Court (Pet. App. 9a-53a) is reported at 16 Cl. Ct. 193.

JURISDICTION

The judgment of the court of appeals was entered on December 19, 1989. A petition for rehearing was denied on March 26, 1990 (Pet. App. 54a). The petition for a writ of certiorari was filed on June 22, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner began manufacturing automated teller machines (ATMs) and selling them to banks and other financial institutions in 1974. Petitioner also maintained and repaired the ATMs under service contracts with the ATM purchasers. Petitioner's ATMs were composed of several separate subassemblies or "modules," each of which performed a discrete function. This modular construction facilitated rapid on-site repairs: a malfunctioning module that could not be repaired quickly would be replaced with a functional module. The faulty module would then be repaired at petitioner's repair center and placed in the pool of spare service modules for use in future ATM repairs. Pet. App. 2a.

During the 1974-1979 period, petitioner accounted for the spare service modules as inventory, *i.e.*, as non-depreciable assets. In October 1980, petitioner filed amended federal income tax returns for 1976 and 1977, the years in issue (as well as for 1978 and 1979), claiming tax refunds resulting from depreciation deductions and investment tax credits based on treating the spare service modules as depreciable property instead of as inventory. The Internal Revenue Service (IRS) disallowed petitioner's refund claims. Pet. App. 2a-3a.

2. Petitioner then commenced this refund action in the United States Claims Court, contending that the spare service modules are properly accounted for as depreciable assets, not as inventory as petitioner had treated them on its original returns. The government moved for summary judgment on the ground that the change petitioner sought to make was a change of accounting method for which petitioner

had failed to request or obtain the prior consent of the Commisioner, as required by Section 446(e) of the Internal Revenue Code.[1]

The Claims Court granted the government's motion for summary judgment (Pet. App. 9a-53a). The court explained that, because the change in question affected the time at which petitioner would recover the cost of manufacturing the spare service modules, it amounted to a change in the treatment of a "material item," and hence of accounting method, within the meaning of Treas. Reg. § 1.446-1(e)(2)(ii)(a) (26 C.F.R.). The court then rejected petitioner's various proffered grounds for avoiding this conclusion. The court stated that petitioner's change was not simply the "correction of mathematical or posting errors," which would not require the consent of the Commissioner, but rather was a change that "drastically altered deduction timing" (Pet. App. 21a-22a). The court proceeded to reject petitioner's contention that Section 446(e) is not applicable whenever the original method of accounting being changed is incorrect (Pet. App. 22a-32a). The court also rejected petitioner's contentions that a taxpayer does not need consent to correct an accounting error in the first year in which it uses that method of accounting (*id.* at 32a-38a), that the policies of Section 446(e) would be frustrated by applying it to petitioner here (Pet. App. 38a-41a), that the audit report reflected the Commissioner's consent to the change (*id.* at 41a-46a), and that considerations of fairness required the Commissioner to allow the

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

change even though petitioner did not request a change of accounting method (*id.* at 46a-50a).[2]

3. The court of appeals affirmed (Pet. App. 1a-8a). It ruled that the change from inventory treatment to depreciation treatment satisfied the regulations' definition of a change in the treatment of a material item because it "involves the proper time for the inclusion of an item in income or the taking of a deduction" (*id.* at 6a, quoting Treas. Reg. § 1.446-1(e)(2)(ii)(a)). Further, the court specifically rejected petitioner's contention that it was merely correcting a "posting error," and stated that petitioner's "argument that it seeks to correct a substantive error independent of its choice of accounting procedures is simply wrong" (Pet. App. 6a). The court also agreed with the Claims Court that, even if petitioner had sought to change from an incorrect to a correct accounting method, that would still be a change in method of accounting requiring the Commissioner's prior consent (*id.* at 6a-7a).

[2] In light of these legal conclusions, the court found it unnecessary to resolve the disputed issues whether petitioner's original method of inventory accounting was a permissible one and whether petitioner commenced this method in 1976 or, as the Commissioner contended, in 1974 (Pet. App. 50a-53a).

ARGUMENT

The court of appeals correctly held that petitioner's attempt to recharacterize its spare service modules as depreciable property, instead of nondepreciable inventory, was a change of accounting method for which the Commissioner's prior consent was required, without regard to whether the change was from an incorrect to a correct method of accounting. This holding is fully consistent with the governing statute and regulations, and it does not conflict with any decision of this Court or of another court of appeals. Accordingly, there is no reason for review by this Court.

1. Section 446(e) of the Code provides: "Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary." Treas. Reg. § 1.446-1(e) implements this provision and defines a change in accounting method in detail. Treas. Reg. § 1.446-1(e)(2)(ii)(a) provides in part as follows:

> A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. * * * A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. * * *

The regulation also provides that "correction of mathematical or posting errors," or the adjustment of items that do *not* involve the proper time for the inclusion of an item in income or the taking of a de-

duction, do not constitute changes of accounting method (Treas. Reg. § 1.446-1(e)(2)(ii)(b)). The question here is the application of these provisions to the particular facts of this case—namely, petitioner's decision to recharacterize its spare service modules as depreciable assets instead of inventory.

As both courts below concluded, the change at issue here—from inventory to depreciable assets—easily falls within the plain terms of the provisions of the regulations. Inventory accounting takes into account the cost of items of inventory in computing the cost of goods sold in a given year. See *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 545 (1979); *Commissioner* v. *Van Raden*, 650 F.2d 1046, 1048 n.1 (9th Cir. 1981). Treating an asset as depreciable property, on the other hand, permits the taxpayer to deduct the cost of the asset in increments over a period of years. See I.R.C. § 167. Changing from inventory to depreciable asset treatment, therefore, manifestly involves the proper time at which a deduction (or reduction of income) may be taken for the cost of the property. Thus, the change affects "the treatment of any material item," and accordingly constitutes a change of accounting method as defined in the regulations. Indeed, the regulations make clear that starting to depreciate an asset that previously had been treated as nondepreciable constitutes an accounting method change (Treas. Reg. § 1.446-1(e)(2)(ii)(b)):

> [F]or example, a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which has been consistently treated as an expense in the year of purchase involves the question of the proper timing of an item, and is to be treated as a change in method of accounting.

2. Petitioner seeks to avoid the plain import of the governing definition by arguing (Pet. 5-11) that when a taxpayer changes from an incorrect method of accounting to a correct one, Section 446(e) does not require that he obtain the prior consent of the Commissioner. This contention finds no support in the statute, and it is directly contrary to the terms of the regulation. Moreover, this contention has repeatedly been rejected by the courts of appeals.

Section 446(e) states that any change of accounting method must be approved in advance by the Commissioner, "[e]xcept as otherwise expressly provided in this chapter." Petitioner points to no provision in the Code that even arguably excludes the change in this case from the purview of Section 446(e), and therefore its contention is refuted by the plain statutory text. Moreover, the applicable regulation explicitly states that a taxpayer who wishes to change his method of accounting must secure the prior consent of the Commissioner "whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder" (Treas. Reg. § 1.446-1(e)(2)(i)). Indeed, several of the examples given in the regulation clearly identify the taxpayer's original method of accounting as one that is not permissible under the Code, but a change of the method is nonetheless identified there as a change that requires the Commissioner's approval. Treas. Reg. 1.446-1(e)(2)(iii), Examples 1, 6-8.[3] Thus, there can be no doubt that the governing regulation

[3] Moreover, the regulation's specific reference to a change in treatment of an asset from nondepreciable to depreciable describes the assets in question as depreciable, and thus also contemplates a change from an improper to a proper method of accounting. See Treas. Reg. § 1.446-1(e)(2)(ii)(b); page 6, *supra*.

has long required a taxpayer to obtain the Commissioner's consent before he changes from an impermissible or improper method of accounting to a permissible or proper one.

The courts of appeals have repeatedly recognized the validity of this aspect of the regulation. In *Witte* v. *Commissioner*, 513 F.2d 391, 394 (D.C. Cir. 1975), the court unequivocally rejected the position advanced by petitioner here as "contrary to the applicable Treasury regulations and subversive of the underlying purpose of section 446(e)'s consent requirement." The court explained the error of petitioner's approach as follows (*ibid.*):

> The purpose of the consent requirement is to enable the Commissioner to prevent distortions of income that often accompany changes in accounting methods by conditioning consent on the taxpayer's agreement to make correcting adjustments in his income tax payments. The danger of distortion of income detrimental to governmental revenues exists regardless of whether the change in method is from one proper method to another or from an improper method to a proper one. The consent requirement has as much vitality in the latter case as in the former.

The court's holding in *Witte* fully accords with the decisions of several other courts of appeals. See *United States* v. *Kleifgen*, 557 F.2d 1293, 1297 n.9 (9th Cir. 1977); *Ed Smithback Plumbing, Inc.* v. *United States*, 209 Ct. Cl. 743 (1976), adopting opinion of trial judge, 37 A.F.T.R.2d 486, 495-496 (1975); *Poorbaugh* v. *United States*, 423 F.2d 157, 163 (3d Cir. 1970); *American Can Co.* v. *Commissioner*, 317 F.2d 604, 606 (2d Cir. 1963), cert. denied, 375 U.S. 993 (1964); *Wright Contracting Co.* v. *Commissioner*, 316 F.2d 249, 254 (5th Cir.), cert.

denied, 375 U.S. 879 (1963); *Commissioner* v. *O. Liquidating Corp.*, 292 F.2d 225 (3d Cir.), cert. denied, 368 U.S. 898 (1961); *Broida, Stone & Thomas, Inc.* v. *United States*, 204 F. Supp. 841, 843 (N.D. W. Va.), aff'd, 309 F.2d 486 (4th Cir. 1962).[4]

3. Disregarding this consistent line of authority, petitioner contends (Pet. 5-11) that the decision below creates a conflict in the circuits. The cases relied upon by petitioner, however, are in no way inconsistent with the decision below. They do not purport to disagree with the rule that Section 446(e) is applicable even where the original method of accounting is incorrect. Rather, in those cases the courts concluded that there was no change in accounting method, based on facts substantially different from those here.

In *W. A. Holt Co.* v. *United States*, 368 F.2d 311 (5th Cir. 1966), for example, the court held that the

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[4] The Tax Court sometimes has not required the consent of the Commissioner to change from a clearly incorrect accounting method to a correct one, notwithstanding the stricter approach taken by the regulations and the courts of appeals. See *Southern Pacific Transportation Co.* v. *Commissioner*, 75 T.C. 497, 682 n.208 (1980). When the Tax Court's decisions in these cases have been appealed, however, they have been reversed. See *Witte* v. *Commissioner, supra*; *American Can Co.* v. *Commissioner, supra.* Moreover, the Tax Court has not consistently adhered to the position described in *Southern Pacific* and, more recently, seems to have abandoned it. For example, in *First National Bank of Gainesville* v. *Commissioner*, 88 T.C. 1069, 1085 (1987), the Tax Court stated that "[w]here the correction of an error results in a change in accounting method, the requirements of section 446(e) are applicable." See also, *e.g.*, *Wayne Bolt & Nut Co.* v. *Commissioner*, 93 T.C. 500, 510-512 (1989); *H. F. Campbell Co.* v. *Commissioner*, 53 T.C. 439, 447-448 (1969), aff'd, 443 F.2d 965 (6th Cir. 1971).

taxpayer's practice of taking bad debt deductions in respect of accounts receivable that were not, in fact, worthless was not a method of accounting. In *Schuster's Express, Inc.* v. *Commissioner*, 66 T.C. 588 (1976), aff'd, 562 F.2d 39 (2d Cir. 1977), the court held that the taxpayer's practice of deducting estimated insurance expenses in excess of the insurance expenses actually incurred did not amount to a method of accounting. The conclusions in both of these cases follow directly from the definition in the regulation. As we have noted (pages 5-6, *supra*), the adjustment of an item that does not involve the proper time for including an item in income or taking a deduction is not a change in method of accounting. Treas. Reg. § 1.446-1(e)(2)(ii)(b). The correction of the taxpayers' erroneous practices in both *Holt* and *Schuster's Express* plainly did not implicate the *timing* of deductions; the taxpayers had taken deductions to which they were not entitled *at any time.*

Here, by contrast, petitioner plainly incurred the cost of producing its spare service modules, and it was entitled to recover that cost ultimately through reductions in income. The issue implicated by the change from inventory to depreciable asset treatment is *when* the cost recovery would occur—upon sale or abandonment of the modules or, alternatively, in annual increments under a method of depreciation. Since the change at issue here does involve a matter of timing it manifestly falls within the regulatory definition of a change of accounting method.

Even more readily distinguishable from this case is *Mamula* v. *Commissioner*, 346 F.2d 1016 (9th Cir. 1965). That case does not address Section 446 or even discuss the question of a change of method of accounting. In *Mamula*, the taxpayer sold real prop-

erty on an installment basis and incorrectly took the position that he could report the gain on a "deferred basis," *i.e.*, that he did not have to report any gain at all until he had recovered the entire cost of the property. The IRS disallowed this treatment of the gain and required the taxpayer to recognize all of his gain in the year of the sale; the IRS thus declined to permit him to elect the installment method of reporting gain, which he clearly could have elected in the first instance. The court of appeals reversed, holding that the taxpayer's decision to report the sale income on a "deferred basis" should not be viewed as a binding election because it was set aside "[a]t the insistence of the government, not the taxpayer" (346 F.2d at 1019). Once the government had disallowed the taxpayer's original method of reporting the gain, the court held, the taxpayer should still be entitled to elect between the two permissible methods of reporting. That decision plainly has no relevance here, where the Commissioner did not disallow petitioner's inventory treatment of the spare service modules (and, indeed, has not contended that inventory treatment was impermissible (see Pet. App. 22a n.3)). Petitioner here chose to change its method of accounting, and the courts below correctly held that Section 446(e) required it to obtain the Commissioner's approval.[5]

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[5] Petitioner also cites (Pet. 10-11) two decisions decided under the predecessor of Section 446 contained in the 1939 Code. As the Claims Court explained (Pet. App. 24a-27a), those cases are not relevant here because the statutory scheme was different. The prior statute did not contain an express provision requiring the prior consent of the Commissioner for a change in accounting method, nor did the regulations thereunder define a change of the kind at issue here as affecting treatment of a "material item" that constitutes a method of accounting. See Section 29.41-2, Treasury Regulations 111

4. Petitioner's contention (Pet. 12-14) that this Court should grant certiorari because the decision below "has the potential for vastly expanding the Commissioner's power" (Pet. 12) is entirely without merit. The decision in this case works no change in the law; it simply applies the terms of an established regulation to a fact situation that is plainly governed by those terms. And, as we have noted (pages 8-9, *supra*), the decision is fully in accord with the decisions of several courts of appeals that have considered and rejected petitioner's position. The authority of the Commissioner to withhold consent to a change of accounting method, subject to review for abuse of discretion, has long been established by the text of Section 446(e). And, contrary to petitioner's implication (Pet. 14), the decision of the court of appeals does not restrict the right of taxpayers to file amended returns to correct errors, substantive or procedural, if the correction of the error does not rise to the level of a change of accounting method.[6] There is no reason for further review.

(1939 Code). In any event, those cases are distinguishable. In *Thompson-King-Tate, Inc.* v. *United States*, 296 F.2d 290 (6th Cir. 1961), the court concluded that the taxpayer had erred in the application of its established completed contract method of accounting; by correcting the error, it was not changing its accounting method. See *id.* at 294-295; Pet. App. 29a. Similarly, in *Beacon Publishing Co.* v. *Commissioner*, 218 F.2d 697, 701-702 (10th Cir. 1955), the court held that the taxpayer was not changing its method of accounting, but was merely correcting an error in the application of its existing accrual method of accounting.

[6] Petitioner errs in asserting (Pet. 13) that a recent revenue ruling demonstrates that "[t]he Internal Revenue Service has already begun to take advantage of the new power vested in it by the Federal Circuit." While the instant case, along with

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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AUGUST 1990

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many others, is cited in support of Rev. Rul. 90-38, 1990-18 I.R.B. 7, it plainly does not form an independent basis for the issuance of that ruling. Rather, the ruling is based on general principles under Section 446 long established by the applicable regulation and the case law. Indeed, the rulings recently revoked or modified by Rev. Rul. 90-38 were identified some years ago by the IRS's technical staff as "incorrect statements of the law." See G.C.M. 39,328 (June 8, 1984), *IRS Positions* [1984-1985 Transfer Binder] (CCH) ¶ 1610, at 5191, 5201.

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No. 89-1999

In The

Supreme Court of the United States

October Term, 1990

Diebold, Incorporated,
Petitioner,
v.

United States,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

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REPLY MEMORANDUM FOR THE PETITIONER

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DIEBOLD, INCORPORATED,
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UNITED STATES,
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On Petition for Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

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REPLY MEMORANDUM FOR THE PETITIONER

In our petition for certiorari (hereafter "Pet."), we noted that this case presents the basic question whether a taxpayer changes his "method of accounting" for purposes of the Internal Revenue Code when he corrects a substantive error that would have been improper under *any* set of accounting procedures.[1] We explained that the decision below, by holding that it is "irrelevant" whether the practice to be corrected would have been improper under all circumstances, conflicts with decisions of other federal courts of appeals and the United States Tax

[1] *See* Pet. ii for compliance with Rule 29.1.

Court. Pet. 5-11. We also argued that the decision below expands the power of the Commission beyond what Congress intended and improperly curtails the right of taxpayers to amend their returns and to file claims for refund. Pet. 12-14.

In its brief in opposition (hereafter "Br. Opp."), the government does not directly defend the court of appeals' ruling that it is irrelevant whether the practice to be corrected would have been improper under any set of accounting procedures. Rather, the government contends (1) that the change at issue here "easily falls within the plain terms of the provisions of the regulations," Br. Opp. 6; (2) that the courts have repeatedly recognized that IRC § 446(e) applies to a change "from an impermissible or improper method of accounting to a permissible or proper one," Br. Opp. 8; and (3) that the decision below does not conflict with decisions of other courts, Br. Opp. 9-11. As demonstrated below, none of the government's contentions has merit.

1. Focusing on the particular correction involved in this case, the government contends that the court of appeals reached the correct result because "the change at issue here—from inventory to depreciable assets—easily falls within the plain terms of the provisions of the regulations." Br. Opp. 6. In support of that contention, the government cites an example given in Treas. Reg. § 1.446-1(e)(2)(ii)(b). Br. Opp. 6.

The example in question is inapposite. It involved not a change from inventory to depreciable assets, but a change from expensing an item to depreciating it. Unlike the former change, the latter change clearly is one "which involves the proper time for . . . the taking of a deduction." Treas. Reg. § 1.446-1(e)(2)(ii)(a). Depreciation as a capital asset and treatment as a current expense both involve deductions from gross income. The very difference between depreciation deductions over several years and deduction as a current expense in a single

year is the time for taking the deduction (ratably over several years or all in the current year). A change from one treatment to the other therefore clearly involves the proper time for the taking of a deduction.

Here, by contrast, Diebold's correction involved not the timing of a deduction, but whether the modules were deductible from gross income at all—or whether, instead, they were to be included in inventory and thus considered in calculating gross income from gross receipts. See Pet. 3 n.2. Moreover, whereas it is often a close question whether an item should be expensed or instead depreciated, there is no question that it is improper to include in inventory items not held for sale. The removal of such items from inventory is merely the correction of a substantive error in miscategorizing an item.[2]

The considerations relevant to the specific correction involved in this case would more appropriately be discussed in a brief on the merits. Suffice it to say that the example in the regulations cited by the government addresses a different situation, and that the decision below has been specifically criticized as reaching an incorrect result. *See* Seago, Horvitz, and Linton, *When Is the Correction of an Error a Change in Taxpayer's Method of Accounting?*, 73 J. Tax'n 76 (1990) ("In *Diebold*, the result appears incorrect.").[3]

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[2] As such, that correction would appear more closely analogous to the examples of corrections of substantive errors cited in Treas. Reg. § 1.446-1(e)(2)(ii)(b). See Pet. 8 n.8.

[3] *See also* 73 J. Tax'n at 79-80 (footnote omitted):

> The taxpayer in *Diebold* lost a substantial investment credit on what would be generally considered a technicality that surely did not serve the purposes of either the investment credit or tax accounting provisions of the Code. Also, Diebold was forced to wait for its income to be recovered through the change in method procedures while the Government enjoyed an interest-free loan.
>
> On the other hand, allowing a taxpayer to correct an erroneous method by filing an amended return would be a step in the

2. The government also attributes to petitioner the contention that, "when a taxpayer changes from an incorrect method of accounting to a correct one, Section 446(e) does not require that he obtain the prior consent of the Commissioner." Br. Opp. 7. That is simply a mischaracterization of petitioner's position. Petitioner makes no claim that § 446(e) is inapplicable whenever the procedure the taxpayer seeks to correct is erroneous.[4] Rather, petitioner contends that § 446(e) does not apply to the correction of a substantive error that would have been improper under any set of accounting procedures.

This distinction explains why the decisions cited by the government at Br. Opp. 8-9 are inapposite. As we noted in our petition, none of those cases "involved a taxpayer who sought to correct a tax treatment that would have been erroneous under any set of accounting procedures." Pet. 8 n.7. The government completely ignores this distinction. In each case cited by the government, the procedure the taxpayer was required to continue to use was one that, if erroneous at all,[5] was erroneous only because of other accounting procedures adopted by the taxpayer.[6]

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direction of simplification. The amended return procedures were created because it was generally recognized that mistakes will be made. It is not apparent why the consequences for mistakes should be so extreme in the case of accounting errors.

[4] Petitioner expressly acknowledged below that § 446(e) can apply "even if the practice the taxpayer seeks to correct was erroneous given the taxpayer's overall method of accounting." Brief for the Appellant, No. 89-1349, at 27 n.24 (citation omitted).

[5] In two of the cases cited by the government, the procedure the taxpayer was required to continue using was not erroneous. *Poorbaugh v. United States*, 423 F.2d 157 (3d Cir. 1970); *Wright Contracting Co. v. Commissioner*, 316 F.2d 249 (5th Cir.), *cert. denied*, 375 U.S. 879 (1963).

[6] For example, in *Hackensack Water Co. v. United States*, 352 F.2d 807, 809-10 (Ct. Cl. 1965), the procedure the taxpayer sought to change—deducting state property taxes when paid rather than when assessed—was not improper in itself, but was suspect only because the taxpayer otherwise used the accrual method for computing income and expense.

By contrast, there is *no* accounting system under which items not held for sale belong in inventory. We know of no case, other than this one, in which a taxpayer was held to be bound to continue to use a tax treatment that was impermissible under any and all circumstances.

3. The government asserts that the decision below does not conflict with the decisions in *W.A. Holt Co. v. United States*, 368 F.2d 311 (5th Cir. 1966), and *Schuster's Express, Inc. v. Commissioner*, 66 T.C. 588 (1976), *aff'd*, 562 F.2d 39 (2d Cir. 1977), because in those cases the taxpayers' erroneous practices did not amount to a "method of accounting." Br. Opp. 10. But it could just as easily be said that including items not held for sale in inventory is not a "method of accounting." Items not held for sale simply do not meet the substantive definition of inventory. See Pet. 3 n.2.[7]

We noted in our petition that the decision of the Federal Circuit in this case conflicts with several decisions of

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[7] The government suggests that the change here involved "the *timing* of deductions." Br. Opp. 10 (emphasis in original). As noted at page 3, *supra*, the change in fact involved whether the items were (1) to be the basis of a deduction or (2) to be included in inventory and thus considered in calculating gross income from gross receipts.

Moreover, contrary to the government's assertion, the correction at issue in *Holt* did implicate timing, but was nevertheless held not to constitute a change in method of accounting because the original tax treatment was substantively improper. The procedure of charging off bad debts in *Holt* was a reserve procedure which takes deductions for bad debts on a ratable basis, over time, rather than at the time when the debts actually become worthless. The Commissioner rejected this procedure because it allowed the taxpayer to take deductions for accounts that were not in fact worthless. As a result, the Commissioner disallowed deductions in a prior year and thereby increased the taxpayer's income for that year, but increased the taxpayer's deductions and thereby reduced its income in the following year. 368 F.2d at 312. Despite the timing consequences of the correction, the Fifth Circuit held that there was no change in method of accounting, because it is simply improper to write off as a bad debt an account that is not worthless.

the United States Tax Court, which have held that the correction of an error in characterizing an item is not a change in method of accounting. Pet. 7-10 & nn. 9-10. With the exception of *Schuster's Express*, the government does not even discuss the Tax Court cases cited by petitioner. It instead relies on three other Tax Court decisions which it suggests are consistent with the Federal Circuit's decision. Br. Opp. 9 n.4. None of those decisions, however, involved the correction of an error in characterizing an item that would have been impermissible under any accounting system. And none questions the distinction recognized in *Underhill v. Commissioner*, 45 T.C. 489, 496 (1966), between changes intended to reflect the true character of an item and changes in the proper method or time for reporting an item the character of which is not in question. That distinction was recognized and applied by the Tax Court as recently as April of this year. *See Coulter Electronics, Inc. v. Commissioner*, 59 T.C.M. (CCH) 350, 365 (1990), *quoted* at Pet. 9 n.9. By declaring that it is "irrelevant" whether the tax treatment to be corrected would be proper under any accounting method, Pet. App. 6a, the Federal Circuit reached a conclusion in conflict with these Tax Court decisions.[8]

There was and still is a direct conflict between the position of the Tax Court and that of the Federal Circuit as to whether a correction of a substantive error, which would have been improper under any set of accounting procedures, constitutes a change in "method of accounting." Taxpayers who face the question whether there has been a change of accounting method that re-

[8] As we noted in the petition, the Claims Court in this case itself noted the conflict between the caselaw in the Tax Court and the caselaw in the Federal Circuit. Pet. 7 n.7; *see also* Reply Brief for the United States in Support of Its Motion for Summary Judgment 9 (Sept. 14, 1987) ("the Tax Court decisions upon which plaintiff relies do not accurately reflect the law, at least in this circuit") (footnote and citations omitted).

quires the Commissioner's prior approval, or instead a correction of an error that does not require such prior approval, should not be governed by different rules depending on whether the issue arises in the context of a deficiency asserted by the IRS (which would permit the taxpayer to go to the Tax Court), or a suit for a refund (which would deny the taxpayer access to the Tax Court). In view of the recurring nature of the issue, this conflict alone warrants review by this Court, so there can be one uniform rule applicable to all similarly situated taxpayers.

CONCLUSION

For the foregoing reasons, and for the reasons set forth in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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